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Comment on 'A Wealth Based Explanation for Earnings Conservatism'

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This interesting and well-done paper posits that managers have different degrees of risk aversion, which are (perhaps) a function of their industry. Since the value of the firm for which the manager works is an important component of his wealth, the manager's risk aversion induces conservatism in financial reporting, where conservatism is defined as an alacrity in reporting bad results and a sluggishness in reporting good results.

The authors test this hypothesis on Dutch reporting data for 1983–1995.[1] The results (panel B of Table VI) appear to bear out the hypothesis: Firms with more risk-averse managers appear to be more conservative in reporting. Substantiating this hypothesis requires 2 separate sets of tests: First the authors measure the risk-aversion of management using the Lambert, Larcker, Verrecchia (LLV) (1991) technique.[2] Then, using a methodology already in the accounting literature, they measure the conservatism of reporting of the firms in the Dutch sample. Correlating the 2 sets of results provides evidence for the main hypothesis of the paper.

The Lubberink-Huijgen paper fits within the positivist, Watts-Zimmerman (1978, 1986), tradition of accounting research in relating reporting to the characteristics of the *reporter*, in addition to the intrinsic nature of the reported numbers themselves.

Having said this, however, the paper raises some interesting questions which it fails to answer. I mention three of these questions below.

The first question has to do with the relation between manager risk-aversion, such as it is, and reporting. The theoretical part of the paper, Section 3, does not really make clear why a more risk-averse manager should be quicker to report bad results (and slower to report good). There is, in fact, no formal theoretical model which gives these results explicitly, even though the authors cite a long series of

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[1] As a sidelight, the authors note that Dutch reporting is likely to be less conservative than that in some other countries, because the legal liabilities in Holland are not as severe as those in some (Anglo-Saxon) environments. The authors do not test whether *internationally-listed* Dutch firms differ in their conservatism from locally-listed Dutch firms. This would make an interesting topic for future research.

[2] All the papers cited in this brief discussion are referenced in the Lubberink-Huijgen paper.

papers which appears to them to support this supposition. I think one could just as easily conclude the opposite: For example, if managers had a short time horizon, then more risk-averse managers should be quicker to report good results (which presumably bring pecuniary benefits) and slower to report bad results.

The second serious question involves the measurement of manager risk-aversion. Here the authors follow LLV in measuring manager risk aversion by differentiating between the wage-based versus the result-based part of manager compensation. The former, presumably, has lower variance than the latter, so that the regression coefficient of wages on the result-based compensation can be said to measure the manager's willingness to assume risks and is perhaps inversely-related to his/her risk aversion. While interesting (and perhaps the only way to measure manager attitudes towards risk), it is clear that the LLV approach is based on a highly-specific set of assumptions: Two of these in particular – that managers' compensation is dominant in their wealth and that the horizon effects favor (given a particular level of risk-aversion) wages for more risk-averse investors – strike me as problematic.

A third problem is the integration between the risk-aversion of managers and the measurement of reporting conservatism. The authors' model (well-embedded in the accounting literature) appears to implicitly assume: (a) the Gordon dividend model with no growth (i.e., a random walk without a trend); (b) no accrual accounting; (c) no debt; and (d) no time-variations in market parameters. For my taste this is a bit too simplistic, even though I have become convinced that the measurement of a more sophisticated model may be a daunting task.

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