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Procedia Social and Behavioral Sciences

Procedia - Social and Behavioral Sciences 164 (2014) 501 – 507

International Conference on Accounting Studies 2014, ICAS 2014, 18-19 August 2014, Kuala Lumpur, Malaysia

The influence of internal governance mechanisms on accounting conservatism

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Abstract

This study empirically examines the association between the attributes of the board of directors and audit committee on accounting conservatism. Results from panel data analysis for 300 Malaysian listed firms observed from 2001 to 2007 show that boards with at least four annually audit committee meetings and higher proportion of independent directors and financial expertise, are faster in recognising bad news into earnings relative to the good news. In addition, it is proven that both independent directors and financial expertise in audit committee nor the board size and CEO duality are associated with conservatism.

Peer-review under responsibility of the School of Accountancy, College of Business, Universiti Utara Malaysia.

Keywords: Board of directors; audit committee; corporate governance; internal governance; accounting conservatism.

1. Introduction

This study investigates the link between board of directors and audit committee with accounting conservatism following the empirical evidence that conservatism mitigates the agency conflict. It is expected that effective board of directors and audit committee with good governance practices would use conservative accounting to assist them in controlling agency conflict and in producing transparent financial reporting. Most studies done before assessed the effectiveness of the board of directors or audit committee on Malaysian financial reporting in relation to

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Peer-review under responsibility of the School of Accountancy, College of Business, Universiti Utara Malaysia.
doi:10.1016/j.sbspro.2014.11.138

earnings management, firm performance, financial distress status and disclosure on corporate social responsibility. None so far has assessed them with conservative accounting. According to a survey performed by Ismail and Abdullah (1999), 73% of the financial analysts agreed with the notions that conservatism can improve earnings quality and it is influenced by the audit committee. However, the study did not provide empirical evidence on the association between audit committees and conservatism. Even if empirical evidence is available, it is mainly from developed countries. For instance, UK studies done by Beekes, Pope and Young (2004) which focused on the board composition; US studies by A. S. Ahmed and Duellman (2007) which examined several characteristics of the board of directors whilst Krishnan and Visvanathan (2008) illustrated attributes of the audit committee in addition to those the board of directors. Thus, there is a need to identify whether their results are applicable in Malaysia, especially for studies on UK firms, since the Malaysian code on corporate governance largely follows the UK code.

This study uses asymmetric timeliness to measure conservatism. The results depict that owning independent directors and financial expertise on board and holding at least four audit committee meetings annually, have positive effects on conservatism. It is also proven that neither independent directors on audit committee, board size nor CEO duality is associated with conservatism.

Significantly, results of this study may benefit policy makers such as Securities Commission and Malaysian Institute of Corporate Governance in assessing the strength of the firms' governance structure. Creditors will also benefit from the findings because comprehending factors that contribute to lower conservatism may assist them in evaluating their client effectively.

The remainder of the paper is organized as follows. Section 2 discusses previous evidence on accounting conservatism and the internal governance mechanisms. Section 3 discusses the research design, regression models and measurements of the variables while Section 4 presents the empirical results and discussions. Lastly, section 5 concludes the paper.

2. Literature review and hypotheses development

2.1. Accounting conservatism

Conservatism is traditionally defined as accounting practices that "anticipate no profit but anticipate all losses" (Bliss, 1924). Watts (2003) stated that the ability of conservatism to limit manager's opportunistic behaviors could increase firms value, and thus protect the interests of minority shareholders. Accounting conservatism benefits corporate governance as losses are recognized immediately, and quick action can be taken to identify underlying reasons. Evidence showed that conservative accounting is more useful in controlling the cost of sub-optimal managerial decisions than if earnings are reported neutrally or liberally (Kwon, 2005). LaFond and Watts (2008) reported that conservatism constrains managers from hiding unfavorable information because accounting conservatism provides hard information on verifiable gains and possible losses. Evidence is proven by Lara, Osma and Neophytou (2009) as UK bankrupt firms practiced lower conservatism prior to their failure. In addition to reducing managers' opportunistic behavior, conservatism ultimately improves the quality of the financial information. For instance, conservatism increased the ability of current earnings to forecast future cash flows (Kim & Kross, 2005); and conservatism increased the value relevance of the earnings since it prevented opportunistic managers from using accounting choices that favored their personal interest (Brown, He, & Teitel, 2006). Furthermore, conservatism reduced managers' incentives to manage earnings because timeliness in incorporating losses into earnings reduces the impact of bad news on the share price (Chen, Hemmer, & Zhang, 2007); and creditors reward firms that employ higher conservatism with lower interest because conservatism provides an early signal to the lender of any possible debt violation (Zhang, 2008).

2.2. Independent directors

A UK study carried out by Beekes et al. (2004) and a US study done by A. S. Ahmed and Duellman (2007), both identified that higher proportions of independent directors on the board were associated with higher levels of conservative accounting. Evidence also shows that audit committee independence mitigates agency conflict (see:

McMullen & Raghunandan, 1996; Saleh, Iskandar, & Rahmat, 2007). On the other hand, Owens-Jackson, Robinson and Shelton (2009) demonstrated that fraud occurred in the reported earnings, even if the committee was comprised wholly of independent directors. This evidence is consistent with the results from meta-analysis carried out by Pomeroy and Thornton (2008) which indicated that audit committee independence is more effective in improving the quality of the audit than the quality of the financial statements. They found that audit committee independence had a weak relationship with accounting accruals and in avoiding financial restatements but was strongly associated with auditor ratification and averting auditor resignation. Krishnan and Visvanathan (2008) found that audit committee independence did not influence accounting conservatism for US firms. This study presents the following hypothesis,
H1: The proportion of independent directors on the board is positively related to conservative accounting.
H2: The proportion of independent directors on the audit committee is positively related to conservative accounting.

2.3. Financial expertise

The findings of Agrawal and Chadha (2005) on US firms showed that outside directors with financial expertise influenced the probability of firms being required to restate their accounts. Guner, Malmendier and Tate (2008) examined several types of financial expertise including financial executives, finance professors and bank executives. Among three types of expertise, only financial executives promoted better governance as they led to less value-destroying acquisition, whilst the others either had no positive contribution to the benefit of the shareholders or led to higher debt even though the firms had low investment opportunities. Previous studies established that financial expertise on the audit committee reduced earnings management (Bedard, Chtourou, & Courteau, 2004), led to less restatement of earnings (Abbott, Parker, & Peters, 2004) and employed more conservative accounting (Krishnan & Visvanathan, 2008). Since, users of the financial statements rely on the competency of directors to oversee the process of the financial reporting; it is more likely that financial expertise employs more conservatism to assist in their governance roles. It is hypothesized that,
H3: The proportion of financial expertise on the board is positively related to conservative accounting.
H4: The proportion of financial expertise on the audit committee is positively related to conservative accounting.

2.4. Board size

Empirical studies provided more support on small board size to be associated with effective governance; where it led to higher returns-earnings relation suggesting that fewer board members were better informed on the earnings of the firm (Vafeas, 2000) and for a significantly small board, adding more members increased the share return but when the size reached a certain limit, adding more directors would reduce performance (Larmou & Vafeas, 2010). Dalton and Dalton (2005) claimed that large board is advantageous in terms of broader knowledge among its members, but Jensen (1993) had argued that the problem of coordination for large board size can outweigh the benefit. Proven by the empirical findings that large board size led to low firm performance (Cheng, 2008; Guest, 2009; Mak & Li, 2001), high earnings management (Rahman & Ali, 2006), low earnings informativeness (K. Ahmed, Hossain, & Adams, 2006) and increased the occurrence of financial distress status (Chang, 2009). This study presents the following hypothesis,
H5: Board size is inversely related to conservative accounting.

2.5. CEO duality

Agency theory argues that CEO and chairman roles should be separated since the board responsibility is to monitor the management including the CEO. The stewardship theory however, perceives that the duality roles improve leadership as there is no information breakdown between the CEO and the board. Jensen (1993, p. 866)

argued that the CEO cannot become the chairman of the board because the chairman needs to independently run the board meeting, oversee the process of hiring, firing, evaluating and compensating the CEO. In contrast, Brickley, Coles and Jarrell (1997) and Klein (1998) argued that the combined structure allows the CEO cum chairman to make timely and optimal decisions and improve the effectiveness of the board because the inside directors possess more knowledge and expertise about the firms' activities which outside directors might be lacking. Empirical evidence has shown that the combined structure was ineffective monitors (Dechow, Sloan, & Sweeney, 1995; Klein, 2002; Muniandy, 2007) whilst the separate structure was proven to be a stronger mechanism (Krishnan & Visvanathan, 2008; Rahman & Haniffa, 2005). This study posits that the joint structure will lead to less conservatism, and hence presents the following hypothesis,
H6: CEO duality is inversely related to conservative accounting.

2.6. Audit committee meeting

Frequency of audit committee meeting is an indication of the diligence of the audit committee members as they would normally resolve issues with the auditors in a formal meeting. Therefore, frequent meetings reflect active committee membership (Raghunandan & Rama, 2007). Empirical studies showed that frequent audit committee meetings led to lower cost of debt (Anderson, Mansi, & Reeb, 2004), reduced the possibility of restatement (Abbott et al., 2004) and lowered fraud occurrence (Owens-Jackson et al., 2009). Accordingly, it is perceived that audit committee members who hold meetings frequently are concerned with the quality of the financial reports; and hence will likely demand more conservatism. This study presents the following hypothesis,
H7: The frequency of audit committee meeting is positively related to conservative accounting.

3. Methodology

This study examined non-financial listed firm on Bursa Malaysia from 2001 to 2007, where in 2001 Malaysian listed firms were required to make mandatory disclosure of the extent of compliance (or non-compliance) with the Malaysian Code on Corporate Governance adopted in 2000.

Asymmetric Timeliness introduced by Basu (1997) is used to measure accounting conservatism. Share returns are used as a proxy for news about firm performance. Timeliness in earnings is measured using a reverse-regression between earnings and contemporaneous returns that captures the difference in the effects of negative returns and positive returns on earnings. A dummy variable (D) interacts with the return variable (*R*) to proxy for bad news (R∗D) whilst the main effect on return (R) is a proxy for good news. Basu's regression model is presented as follows:

$$E_{it}/P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 D_{it} + \beta_3 R_{it}{*}D_{it} + \varepsilon_{it} \quad (1)$$

The sensitivity of earnings to good news is measured by the β_1 estimate while sensitivity of earnings to bad news is measured by $\beta_1 + \beta_3$. Positive coefficients are predicted for intercept (β_0) and return (β_1). The positive sign for the intercept reflects the realised gain (good news) from previous periods recognised in the current year (Basu, 1997). The value of β_3 reflecting the incremental sensitivity of earnings to bad news compared to good news, and thus measures accounting conservatism. The coefficient of β_3 is commonly referred to as 'asymmetric timeliness'. Under greater conservatism, earnings will have higher sensitivity to bad news as compared to good news. Accordingly, β_3 is expected to be larger than zero.

To test the hypothesized relationships, each attribute of the board of directors and audit committee was interacted with each variable in Basu's original model, as shown in equation 2. The coefficient of the interaction term R*D with the variable, represents the effect of the respective variable on asymmetric timeliness. For instance, the effect of BID on asymmetric timeliness, is observed on β_7, which is the coefficient of the interaction term of R*D with independent directors on the board (BID*R*D). If independent directors on the board employ more conservatism, β_7 is expected to be positive. Similar interactions were made with the remaining independent variables; BF to MTB, but are not shown for clarity purposes.

$$E_{it}/P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 D_{it} + \beta_3 R_{it}*D_{it} + \beta_4 BID_{it} + \beta_5 BID_{it}*R_{it} + \beta_6 BID_{it}*D_{it} + \beta_7 BID_{it}*R_{it}*D_{it} + Other\ Internal\ Governance\ Variables\ and\ Control\ Variables_{it} + \varepsilon_{it} \quad (2)$$

Six control variables included are ownership concentration, auditor, firm size (total assets), profitability, leverage and market to book ratio.

4. Empirical results

Regression results in Table 1 showed that BID, BF and ACM were significantly related to asymmetric timeliness. The positive significant coefficients on BID*RD and BF*RD imply that the higher the proportion of independent directors and financial expertise on the board, the faster the bad news is recognized into earnings relative to good news. The results are consistent with Beekes et al.'s (2004) and A. S. Ahmed and Duellman's (2007) evidence on UK and US firms respectively. It also signifies the importance of accounting knowledge for directors to control manipulation or produce transparent financial information. This result supports previous studies that highlighted the importance of financial experts (e.g.: Rahmat, Iskandar, & Saleh, 2009; Rose & Rose, 2008). Positive significant coefficient on ACM has proven that the minimum of four meetings held annually promotes effective function of audit committee.

Table 1. Regression Results of Asymmetric Timeliness

$E_{it}/P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 D_{it} + \beta_3 R_{it}*D_{it} + \beta_4 BID_{it} + \beta_5 BID_{it}*R_{it} + \beta_6 BID_{it}*D_{it} + \beta_7 BID_{it}*R_{it}*D_{it}$ + *Other Internal Governance Variables and Control Variables*$_{it} + \varepsilon_{it}$

	Predicted Sign	Coefficient	t-value
BID*R	-	-0.50	-7.36***
BID*R*D	+	1.45	**3.72*** **
ACID*R	-	0.14	1.45
ACID*R*D	+	-0.26	-1.60
BF*R	-	-0.87	-11.96***
BF*R*D	+	0.52	**1.78***
ACF*R	-	0.36	3.00***
ACF*R*D	+	0.14	0.77
BS*R	+	-0.10	-3.57***
BS*R*D	-	-0.19	-1.16
BCD*R	+	-0.08	-5.20***
BCD*R*D	-	-0.11	-1.24
ACM*R	-	-0.02	-0.43
ACM*R*D	+	0.31	**2.20***
Control variables Included			Yes
F- value			**14.22*** **
R^2 within			.2241
N			2002

***p<0.01; **p<0.05;* p<0.10

BID= Proportion of independent directors on board, ACID= Proportion of independent directors on audit committee, BF= Proportion of board members with financial expertise, ACF= Proportion of audit committee members with financial expertise, BS= Natural logarithm of board size, BCD= Dummy equal 1 if CEO-Chairman roles combine, 0 otherwise, ACM= Dummy equal 1 if audit committee meetings held per year is four times or more, 0 otherwise.

+R^2 within is used as a measure of goodness of fit for fixed-effect regression model (StataCorp, 2009). +Reported t-values were estimated based on Driscoll and Kraay's (1998) method which is robust to cross-sectional dependence, heteroskedasticity and autocorrelation.

ACID was found not significant. Significant coefficients for BS*R, BCD*R and ACF*R suggested that these attributes had a significant influence on the recognition of good news into earnings, but they had no influence on asymmetric timeliness. Bonn, Yoshikawa and Phan (2004) argued that board size is only a factual number of directors, and does not reflect the directors' skill and knowledge, essential for a board to function effectively. Since independent directors and financial expertise on the board had a strong positive impact on asymmetric timeliness, it can be assumed that the size of the board might not be an issue as there are other mechanisms working effectively to monitor the financial reporting process. Besides, CEO duality also had no influence on asymmetric timeliness, although nearly 95% of the sample firms split the CEO-chairman roles. The result also proposed that split or combined roles is not relevant to the firms conservatism practices which is consistent to the findings of A. S. Ahmed and Duellman (2007). Eventually, the results also supported the findings of Dahya et al. (2009) and affirmed that though separating the two roles had been a major practice in Malaysian firms, it did not have a demonstrably favourable effect on the financial reports.

5. Conclusion

The empirical results in this study affirm the prediction that the proportions of independent directors and financial expertise on the board have positive effect on conservatism. Audit committee meeting leads to more conservatism as measured at a threshold of four meetings and above. The findings further suggest that independent directors and financial expertise on audit committee do not influence conservatism. Besides, no significant association is found for board size and CEO duality. Finally, the results reported in this study imply that a good internal governance structure is able to promote other governance mechanisms such as accounting conservatism, and hence strengthen the corporate governance of Malaysian firms.

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