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Board independence and accounting conservatism in Malaysian companies

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Abstract

This paper examines the relationship between board independence and accounting conservatism among Malaysian companies in year 2000 until 2012. What triggers the researchers to carry out this study is that studies found that the implementation of Malaysian Code of Corporate Governance to Malaysian companies has created a higher confidence level to investors and enhances the company's image. Further, one of the elements of good corporate governance is the board independence. However, few studies discuss on accounting conservatism. It is argued that accounting conservatism is an effective mechanism to address the agency problem. Based on the findings, interestingly, this study found that higher board independence does not align with higher conservatism. Instead, the independent non-executive directors do not actually have the power of 'independence', monitoring and advising the board of directors.

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Keywords: Board independence, accounting conservatism, Malaysia.

1. Introduction

The Malaysian Code of Corporate Governance was issued in March 2000. It marked a significant milestone in corporate governance reforms in Malaysia. The Code became effective through the revamped Listing Requirements of the KLSE in January 2001. Since the release of the Code, the Malaysian corporate scene has

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made significant strides in corporate governance standards. Later a revised version of the Code was released in 2007. The key amendments to the revised Code were aimed at strengthening the board of directors and audit committees, and ensuring that the board of directors and audit committees discharge their roles and responsibilities effectively. The KLSE-PricewaterhouseCoopers Corporate Governance Survey 2002 found that the reform in Malaysia is headed in the right direction. The survey results indicate that 93% of the investors surveyed felt that Malaysia's standard of corporate governance has improved since the introduction of the Code in 2000.

Corporate governance complements conservatism in facilitating contracting in that it promotes conservatism to be adopted in financial reporting (Fama & Jensen, 1983). A number of studies examine the association of board characteristics with the quality of financial reporting. Beasley (1996), Dechow et al. (1996) and Farber (2005) find that the percentage of outside directors is negatively related to the likelihood of fraud. Peasnell et al. (2000), Klein (2002) and Xie et al. (2003) document a negative relationship between the percentage of outside directors and proxies for earnings management. Wright (1997) reports a positive relationship between the percentage of outside directors and analyst ratings of financial reporting quality.

Accounting conservatism is found to be an important elements in good quality financial reporting (Ball, Robin, & Wu, 2003; Beekes, Pope, & Young, 2004; Fan & Wong, 2002). Accounting conservatism requires a firm to recognize losses more quickly than gains. It understates earnings and net assets, and thereby it reduces the ability of managers to engage in activities that will benefit themselves. It is argued that accounting conservatism is an effective mechanism to address agency problem. It is a useful tool for the board of director to fulfil its role in monitoring manager (Watt, 2003; Ahmed & Duellman, 2007). Thus, by having strong corporate governance and higher accounting conservatism, it will enhance the quality of financial reporting of the company.

Given that the role of the board of director is to monitor manager behaviour and accounting conservatism is a good measure to address agency problem, it is important to understand the link between board independence and accounting conservatism. In this paper, this study will examine the association of board characteristics with accounting conservatism. The contribution of this paper is that shed evidence whether firms with effective board characteristics employ accounting conservatism as a tool to address agency problem.

2. Literature review and hypothesis development

2.1 Malaysian Code of Corporate Governance (MCCG)

The release of the Code has marked the importance of corporate governance in Malaysia. Corporate governance in Malaysia is established based on the Anglo-Saxon approach, as in the US and UK. The Code was mainly derived from the recommendations in the Cadbury Report (1992) and the Hampel Report (1998) in the UK. The Code was issued in March 2000. It marked a significant milestone in corporate governance reform in Malaysia. The Code consists of the principles, best practices of good governance, optimal corporate governance structures and internal processes. The Code became effective through the revamped Listing Requirements of the KLSE in January 2001. Since the release of the Code, the Malaysian corporate scene has made significant strides in corporate governance standards. The mandatory reporting of compliance with the Code has enabled shareholders and the public to assess and determine the standards of corporate governance by listed companies.

Later a revised version of the Code was released in 2007 and latest in 2012. The revised Code (2012) represents the continued collaborative efforts between the Government and industry. The key amendments to the revised Code were aimed at strengthening the board of directors and audit committees, and ensuring that the board of directors and audit committees discharge their roles and responsibilities effectively. A survey on corporate governance has been conducted in year 2006 by Minority Shareholder Watchdog Group (MSWG) and Nottingham University Business School (NUBS) with the objective to measure the level of compliance of top 200 public listed companies. The main findings indicate that the level of compliance of the top 200 PLCs with the Code and best practices is rising and that for a number of PLCs, the level was approaching maximum compliance as reflected by the basic compliance score. However, the findings of the international best practices imply that generally Malaysian PLCs are still lagging behind in competitiveness with recommended best practices not already enjoined by the Code.

2.2 Accounting conservatism

In relation to corporate governance issues, accounting conservatism is an effective mechanism to reduce agency problem as it curbs managers' opportunistic behaviour. It reduces the ability of managers to overstate earnings and net assets (Watts, 2003). Furthermore, accounting conservatism discourages managers to invest in negative NPV projects or poorly performing investments as they are unable to defer recognition of losses to the future (Ball & Shivakumar, 2005). Habib and Hossain (2013) evidenced that in Australia, accounting conservatism positively affects a firm's leverage structure.

Prior research indicated that accounting conservatism is associated with high quality financial reporting. For example, Hu, Li and Zhang (2014) found that conservatism positively associated with the improvement of corporate information environment. Conservatism is more pronounced in countries with weaker protection of property rights. Accounting conservatism is higher for firms that have good corporate governance mechanisms. Firms with a higher proportion of outside directors recognize losses on a timelier basis than firms with fewer outside directors (Beekes et al., 2004; Ahmed & Duellman, 2007; Lara, Osma & Penalve, 2007). LaFond and Roychowdhury (2008) and Cullinan et al. (2012) find that accounting conservatism is negatively associated with managerial ownership. Study in US found that banks with effective governance structures practice higher levels of accounting conservatism (Leventis, Dimitropoulos & Owusu-Ansah, 2013).

2.3 Board independence

One of the components of corporate governance is the board independence. Board independence is measured by its composition. For effective monitoring, the board of directors should consist of the right number of independent non-executive directors. According to Hillman and Dalziel (2003), the board is independent when there are a significant proportion of independent non-executive directors. Non-executive directors are more effective in monitoring managers and protecting the interest of shareholders and thereby reducing agency problem (Brickley & James, 1987; Weisbach, 1988; Byrd & Hickman, 1992; Craven & Wallace, 2001). Fama (1980) and Fama and Jensen (1983) argue that non-executive directors enhance the effectiveness of internal control as most non-executive directors are important decision agents in other corporations. Ahmed and Henry (2012) found that firms voluntarily adopting perceived best practice corporate governance mechanisms (voluntarily audit committee formation, increasing board independence and decreasing board size) employ unconditional accounting conservatism as a complimentary agency control device.

The Code recommends that non-executive directors should be persons of calibre, credibility and possess necessary skills and experience. Furthermore, at least one third of the board members should consist of independent non-executive directors for the board to be effective. According to Abdullah (2001), boards of directors of Malaysian firms are generally dominated by non-executive directors. Prior studies indicate that board independence promotes high quality financial reporting. Study by Lin, Fan and Cheng (2012) show that listed companies in China have accounting conservatism in their accounting policies. The increasing percentage of independent directors in the board benefits the improvement of accounting conservatism. Peasnell et al. (2000), Klein (2002), Xie et al. (2003) and Bowen et al. (2005) document that earnings management is low when the percentage of outside directors is high. Studies in Malaysia, however, find that there is no relationship between non-executive directors and earnings management (Mohd-Salleh et al., 2005; Abdul Rahman & Mohamed Ali, 2006). Agency theory suggests that higher proportion of non-executive directors increases the effectiveness of the board. Prior studies indicate that higher proportion of non-executive directors on board to be more conservative (Beekes et al., 2004; Ahmed & Duellman, 2007; Lim, 2011). Based on the arguments above, we hypothesize that:

H_1: Higher proportion of independent non-executive directors lead to higher accounting conservatism for companies.

3. Research method

3.1 Sample

This study uses the company annual reports and financial database from year 2000 to 2012 in gathering the necessary information for 866 companies except for banking and other finance related companies. Year 2000 to 2012 were selected because researchers want to examine the pre (2000 &2007) and post (2012) effect of MCCG.The data on company annual reports were retrieved from the Bursa Malaysia. The financial data were extracted from the Thomson Advance Database.

3.2 Research model and measurement

This study uses Basu's (1997) measure as our measure of conservatism. Basu defines conservatism as earnings capture bad news faster than good news. Using stock returns to proxy for good and bad news, Basu expected that in a reverse regression of earnings on stock returns, a higher association of earnings with negative stock returns than with positive stock returns would be observed. Basu's regression model is as follow:

$$E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \varepsilon_t$$

where E_t is annual earnings deflated by the beginning of period market value, R_t is a twelve-month stock return, D_t is a dummy variable that equals one if stock return is negative and equals zero otherwise, and ε_t is the residual term. The coefficient $\beta_3$measures the sensitivity of earnings to negative stock returns and it is expected to be positive and significant when earnings are more sensitive to negative stock returns than to positive stock returns. We extend the Basu (1997) model by including the variables for board characteristics variables to examine the association of board independence with accounting conservatism. The estimating equation is as follow:

$$E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \varepsilon_t$$

$$E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \beta_4 INDEPENDENCE_t + \beta_5 INDEPENDENCE_t.D_t + \beta_6 INDEPENDENCE_t.R_t + \beta_7 INDEPENDENCE_t.D_t.R_t + \varepsilon_t$$

where E_t is annual earnings deflated by the beginning of period market value, $D_t$is a dummy variable that equals one if stock return is negative and equals zero otherwise, $R_t$is a twelve-month stock return, $INDEPENDENCE_t$ represents board independence that equals one when the number of non-executive directors is above the sample median and equals zero otherwise.

4. Findings and discussion

Based on the analysis in Table 1, Model 1 shows that the value of stock return is significant (coef. = 0.017, p=0.013) and when stock return interact with the dummy value, it also show a positive significant effect (coef. = 0.125, p=0.000). This implies that stock return is sensitive to change in time. Model 2 reveals that board independence is negatively related with accounting conservatism (coef. = -0.089, p=0.052). This indicates that even the number of independent non-executive directors is high, but shows a low level of conservatism. The independent non-executive directors actually perform little role of monitoring the board because they are lack of real independence, time, as well as not enough information (Gilson & Kraakman, 1991; Patton & Baker, 1987). Our findings also contradict with previous studies (Ahmed & Duellman, 2007; Lara, Osma & Penalve, 2007).

Table 1: Regression Results for Earnings on Stock Returns and Board Independence

	Model 1[a]	Model 2[b]
Intercept	0.078***	0.077***
	(0.000)	(0.000)
D	0.004	0.003
	(0.464)	(0.670)
R	0.017**	0.011
	(0.013)	(0.144)
D*R	0.125***	0.144***
	(0.000)	(0.000)
INDEPENDENCE		0.002
		(0.752)
INDEPENDENCE*D		0.003
		(0.813)
INDEPENDENCE*R		0.019
		(0.864)
INDEPENDENCE*D*R		-0.089**
		(0.052)

*Significant at 10%, **Significant at 5%, ***Significant at 1% (figures in the parentheses are the p-values).

[a] $E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + e_t$

[b] $E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \beta_4 INDEPENDENCE_t + \beta_5 INDEPENDENCE_t.D_t + \beta_6 INDEPENDENCE_t.R_t + \beta_7 INDEPENDENCE_t.D_t.R_t + e_t$

E_t is annual earnings deflated by the beginning of period market value, $R_t$is a twelve-month stock return measured from eight months prior to the fiscal year through four months after the fiscal year end, $D_t$is a dummy variable that equals one if stock return is negative and equals zero otherwise, *INDEPENDENCE* represents board independence that equals one when the number of non-executive directors is above the sample median and equals zero otherwise, and ε_t is the residual term.

5. Conclusion

In a nutshell, the role of independent non-executive directors is still lacking behind in influencing the accounting conservatism. Even though the Code has been introduced for nearly 13 years, but yet the effectiveness of role of independent non-executive directors is still being questioned. The Code is being complied in terms of composition, but not the role of the independent non-executive directors. In terms of theory and practical contribution, corporate governance theory is applied in practice. However, future research may consider interview method to enrich the data collection and findings of the study.

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