

## THE EFFECTS OF CHARACTERISTICS OF THE BOARD ON ACCOUNTING CONSERVATISM IN MALAYSIA AND SINGAPORE

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### ABSTRACT

To examine whether corporate governance could be seen as an explanation for accounting conservatism, this research therefore aimed to answer the following research main question: “Do characteristics of the board including board size, the proportion of independent board, and audit committee size have the effects on accounting conservatism in Malaysia and Singapore?” The research results could provide more information to involved stakeholders, especially investors interested in investing in ASEAN market. This research used 389 samples, comprising 244 firms from Bursa Malaysia and 145 firms from Singapore Exchange, excluding financial firms. Data were analyzed by using the multiple regression. The research results were explained with both notion of large and small board members on accounting conservatism.

**Keywords:** Corporate governance, Board size, Independent board, Audit committee, Accounting conservatism

### Introduction

ASEAN Economic Community or AEC was established in 2015 by 10 member countries. It is the largest market in terms of the population size (Onyusheva et al., 2018). Both Malaysia and Singapore are countries in AEC, and they are the ones of the most diverse regions of the world (Sofjan, 2016). In Malaysia, the major religious groups include Islamic, Christianity, Buddhism, and Hinduism (Nathan, 2016). Meanwhile, the resident population in Singapore are Chinese, Malaysian, Indian, and others (Singh, 2016). According to the 1997 Asian Financial Crisis, Malaysia was one of the most affected countries. This crisis was discussed to cause

from poor corporate governance and outbreak in Asia (Nam & Nam, 2004). Reforms in corporate governance were then established, and Asian countries were introduced after that (Cabalu, 2005). The Malaysian Code on Corporate Governance (MCCG) was issued by Malaysian government in March 2000. In addition, to protect the interest of minority shareholders, the Minority Shareholders Watchdog Group (MSWG) was also established in 2000 (Sejati & Jones, 2019). For Singapore, although it was affected by the 1997 Asian Financial Crisis less than Malaysia, the reform and restructuring of the country's response policy to this crisis was further established to ensure international competitiveness (Yue, 1998).

Corporate governance is the system used to control the firms, and it is mainly participated with management and ownership issues (Kootanaee et al., 2013). Among corporate governance mechanism, the board of directors elected by shareholders are important since the decisions made by the board would be adopted by the management. These decisions affect not only the operations of the business but also the survival of the business (Kajola et al., 2017). This is also supported by the statement of Raheja (2005) that board structure affects the flow of information, and in inferior projects it is replaced with superior ones with the effectiveness of the corporate board (Raheja, 2005). The board requires the combination of executive and non-executive directors to pursue the shareholders' interest. The non-executive directors on the board will be able to exercise their duties effectively. Besides, when they are independent from the management and ensure that they are unbiased, they are entrusted by shareholders to represent them and will help reduce agency problems (Fuzi et al., 2016). The code of corporate governance and regulators also recommend that the composition of board members should be balanced and consist of independent directors (Fuzi et al., 2016). Moreover, the boards are composed of different sub-committees, which the audit committee is one of them (Wu et al., 2012). The board formed an audit committee in order to assist them in their task. The audit committee oversees the management doing the financial reporting process, and their role is often linked to the quality of financial reporting. Thus, the existence of the audit committee should be able to improve the quality of financial reporting and the firm's internal control quality leading to shareholders' protection (Supriyaningsih & Fuad, 2016). Larger boards are expected to

have directors with diverse education, industry backgrounds, and skills with multiple perspectives to improve the quality of the firms' operations (Zahra & Pearce, 1989). In addition, Conger, Finegold, and Lawler (1998) further explained that the combination between experience and knowledge of board members must be consistent with the strategic demands with which firms are facing. Moreover, the business environment today is more complex, so it is impossible in practice that a single board or even a small group of individuals of the board would understand all of the issues (Conger et al., 1998). Meanwhile, in addition to increase the ability to control management, a small board could decrease problems of communication and coordination with which a large board has faced (Jensen, 1993; Yermack, 1996). The previous studies showed the mixed results about board size and firm performance. Board size was positively related to firm performance (Bathula, 2008; Johl et al., 2015). Nevertheless, some studies pointed out that board size was negatively related to firm performance (Guest, 2009; Mak & Kusnadi, 2005; Nguyen et al., 2016). Other aspects found that there was no significant relationship between board size and firm performance (Topak, 2011; Wang, Young, & Chaplin, 2009). Furthermore, previous research revealed that independent directors and firm performance were also mixed. Fuzi, Halim, and Julizaerma (2016) said that the highest number of independent directors of the firms would not assure to enhance firm performance (Fuzi et al., 2016). Besides, there is a need for the firms to have an audit committee that is not too small such that there is lack of expert advice and too large such that it has free riders that are prone to follow other members opinion (Kipkoech, 2016). Unlike Zraiq and Fadzil (2018), they studied the

relationship between audit committee size and firm performance in the emerging market of Jordan, and their finding indicated a positive direction but insignificant relationship between audit committee size and firm performance in terms of ROA (Zraiq & Fadzil, 2018).

ASEAN investment liberalization initiatives post-2015 leads to a situation with no border trade. Due to the study entitled “ASEAN: Problems of Regional Integration” of Onyusheva, Thammashote, and Kot (2018), one of their suggestions was that the related parties should provide and share more information in order to enhance the awareness of all stakeholders (Onyusheva et al., 2018). The stakeholders need both financial and non-financial information to analyze and evaluate firm performance for supporting the decision making. Kothari (2000) defines the quality of financial information as a function of both the quality of (accounting) standards governing the disclosure of accounting information and the regulatory enforcement or corporate application of the standards in an economy (Kothari, 2000). Conservatism as one of qualitative characteristics of financial reporting was discovered to make better quality of financial information (Mohammadi et al., 2013). It leads to the reduction of information asymmetry (information risk) and the protection of investors as one of stakeholders (Sofian et al., 2011). Vichitsarawong, Eng, and Meek (2010) studied the impact of the Asian Financial Crisis on accounting conservatism in Hong Kong, Malaysia, Singapore, and Thailand and found that corporate governance reforms in these four countries had such a positive impact on accounting conservatism (Vichitsarawong et al., 2010). Focusing on a sub-component of corporate governance principle, which is board of directors, Boussaid, Hamza, and

Sougné (2015) suggested that in French firms, board of directors' attributes are the important factors in determining the financial reporting quality (Boussaid et al., 2015). Consistent with some other studies, they found to be related to accounting conservatism which makes the accounting information achieve quality (Chan et al., 2009; Fan & Zhang, 2012).

With the joint entry of Malaysia and Singapore to AEC, it has created the environment for their businesses and help expand their market reach (AIMO, 2015). In addition to the study of Sultana, Zahn, and Singh (2016), it showed that board of directors are more independent, and having independent members who are financially qualified and meet more frequently were more likely to be associated with more accounting conservatism (Sultana et al., 2016). Meanwhile, the various studies pointed out that audit committee attributes such as expertise in accounting and finance were related to financial reporting quality (Hamdan et al., 2012; Kamarudin & Ismail, 2014; Kipkoech, 2016; Kusnadi et al., 2015). Moreover, according to the finding of Leong et al. (2015), since audit committees of listed firms on Singapore Exchange have already consisted of a majority of independent directors, the researchers did not find an evidence that incremental independence of audit committees improve quality of financial reporting (Kusnadi et al., 2015).

### **Research Objective**

To study the effects of characteristics of the board, including board size, the proportion of independent board, and its sub-committee: audit committee size, on accounting conservatism of the firms in Malaysia and Singapore.

## **Research Hypotheses**

As Malaysia and Singapore are the members of AEC, this research expected that the notion of large member and more accounting conservatism should be appropriate in the explanation of board size and the proportion of independent board. For audit committee size, the expertise in accounting and finance are confirmed to be the key attribute of audit committee by both corporate governance code and various research papers, so audit committee size may not have an effect on accounting conservatism. Thus, the research hypotheses were shown as follows:

- Board size has a positive effect on accounting conservatism of firms in Malaysia and Singapore.
- The proportion of independent board has a positive effect on accounting conservatism of firms in Malaysia and Singapore.
- Audit committee size does not have an effect on accounting conservatism of firms in Malaysia and Singapore.

## **Literature Review**

### **Accounting conservatism**

Accounting conservatism is defined as the differential verifiability required for recognition of profits versus losses, by “anticipate no profit, but anticipate all losses” (Watts, 2002). It has long been recognized as one of the fundamental characteristics of financial accounting (Blunck, 2007). Abdul-Malik (2017) reported that the accounting conservatism differs in each country, and investors will be protected in the country that is more conservative in financial reporting (Abdul-Malik, 2017). Firm that has strong corporate governance usually protects investors by informing about bad news in a timely manner (García Lara et al., 2009) implying that accounting conservatism can protect investors.

### **Board size and accounting conservatism**

Several previous studies suggested that corporate governance mechanisms could increase the level of accounting conservatism (Almutairi & Quttainah, 2019; García Lara et al., 2009; Saeed & Saeed, 2018; Suleiman & Anifowose, 2014; Vishnani & Bhatia, 2019). Nonetheless, some studies provided different results. Kootanaee and colleagues (2013) found that there was no significant relationship between corporate governance and accounting conservatism (Kootanaee et al., 2013). Concentration on board size and accounting conservatism was also unconcluded. The board size did not have a significant effect on accounting conservatism (Al-Sraheen et al., 2014; El-Habashy, 2019). However, Ahmed and Henry (2012) found that the relationship between unconditional accounting conservatism and conditional conservatism was not the same as the relationship with board size (Ahmed & Henry, 2012). The different results from the studies of Boussaid, Hamza, and Sougné (2015) and Suleiman (2014) pointed out the negative influence of board size on accounting conservatism (Boussaid et al., 2015; Suleiman, 2014).

### **Independent board and accounting conservatism**

El-Habashy (2019) investigated the corporate governance attributes which influence the level of accounting conservatism in Egyptian listed firms during the period of 2009-2014, and their suggestions were that non-executive directors use conservative accounting as a tool to reduce agency problems and facilitate management control. They also pointed out that non-executive directors were likely to adopt more conservative accounting (El-Habashy, 2019), and this result was in line with the study of Nasr and Ntim (2018) which found there was a positive association

between board independence and accounting conservatism (Nasr & Ntim, 2018). Unlike the study of Amran and Manaf (2014) on the relationship between board independence and accounting conservatism among Malaysian companies in year of 2000-2012, they pointed out that the independent non-executive directors did not actually have the power of independence, monitoring and advising the board of directors, and then higher board independence did not align with higher conservatism (Amran & Manaf, 2014). Consequently, these aforementioned different results are unlike the finding of Aishah Hashim and Devi (2008) who found that board independence was not associated with earnings quality. Due to the explanation in the study of Jaggi, Leung, and Gul (2009), it was because the monitoring effectiveness of independent corporate boards is moderated in family-controlled firms (Jaggi et al., 2009) that are dominant in Asian corporations (Aishah Hashim & Devi, 2008).

#### **Audit committee size and accounting conservatism**

Ayemere and Elijah (2015) studied about audit committee attributes of listed firms on the Nigeria Stock Exchange during 2006-2013, and their finding showed that audit committee financial expertise, audit committee size, and audit committee independence and diligence had significant positive relationships with the quality of financial reporting (Ayemere & Elijah, 2015), but this was inconsistent with some previous studies. Hamdan, Al-Hayale, and Aboagela (2012) investigated the impact of audit committee characteristics including size, independence, activity, financial expertise, and percentage of common stocks owned on improving accounting conservatism. They found that only the financial experience characteristic had a positive relationship with conservatism

(Hamdan et al., 2012). Furthermore, Huang and Thiruvadi (2010) found that the number of audit committee members did not significantly affect fraud prevention (Huang & Thiruvadi, 2010). Besides, Habbash (2012) also found that the monitoring effectiveness of audit committees was moderated in firms with high block holder ownership (Habbash, 2012).

#### **Conservatism measurement**

The three types that researchers usually use to assess accounting conservatism are 1) net asset measures 2) earnings and accrual measures, and 3) earnings/stock returns relation measures (Watts, 2003). This research followed the study of Dechow, Ge, and Schrand (2010) which reviewed the earnings quality in terms of proxies, determinants, and consequences. Besides, there are four or more papers that studied the determinant of governance and board characteristic which used discretionary as the proxy and consequences are stock returns, cost of capital, and analyst decisions (Dechow et al., 2010). This background came from the conservatism which implies the asymmetric recognition of gain and loss where loss is to be fully accrued but gain is not (Watts, 2003). Givoly and Hayn (2000) said that the conservatism had the effect on persistently negative accruals. They found out that more conservative accounting is reflected by more negative average accruals (Givoly & Hayn, 2000). Since earnings is the sum of cash flow and accruals, if unrealized losses but not unrealized gains are recognized, then earnings is more conservative than cash flow (Basu, 1997). This was based on the concept that discretionary accruals are open to managers' manipulation. In addition, non-discretionary accruals reflect the non-manipulated accounting accruals items because they are out of managers' control. Abed, Al-Badainah, and

Serdaneh (2012) used discretionary accruals as a proxy for earnings management, and they found out that conservatism was negatively related to earnings management (Abed et al., 2012). Consistent with the studies of Karami, Taban, and Aleyasin (2014) and Lobo and Zhou (2006), they identified that a decrease in discretionary accruals would indicate an increase in conservatism (Karami et al., 2014; Lobo & Zhou, 2006).

## Research Methodology

The population in this research were registered firms which operated and submitted the annual report in 2018 including 789 firms from Bursa Malaysia and 488 firms from Singapore Exchange. As a result, the sampling firms from Bursa Malaysia and Singapore Exchange were drawn to 244 firms and 145 firms, respectively as shown in details in table 1 as follows:

Table 1 Sample of this research

	Bursa Malaysia	Singapore exchange	Total
All listed firms	789	488	1,277
Less financial firms	31	22	53
Loss firms	127	47	174
Incomplete firms	54	138	192
Non calendar year accounting period of firms	333	136	469
Sample	<b>244</b>	<b>145</b>	<b>389</b>

Financial firms were excluded in this research because they have fundamentally different financial structures, cash flow, and accrual processes (Bradbury et al., 2006). Data were collected from secondary source through the

annual report of listed firms on their websites. Then, the data were analyzed by using the multiple regression. The three independent variables were as follows:

- Board size (*BS*) = Total number of board members  
 Independent board (*IB*) = The proportion of independent directors on the board  
 Audit committee (*AuC*) = Total number of Audit committee members

The dependent variable: Accounting conservatism (*AC*) was measured by using the model of Ball and Shivakumar (Ball & Shivakumar, 2006) as shown in equation (1) and (2).

$$TA_{it}/A_{i,t-1} = \beta_0 + \beta_1(I/A_{i,t-1}) + \beta_2(\Delta Rev_{it}/A_{i,t-1} - \Delta Rec_{it}/A_{i,t-1}) + \beta_3(PPE_{it}/A_{i,t-1}) + \beta_4(CFO_{it}/A_{i,t-1}) + \beta_5[(NEG\_CFO_{i,t})/A_{i,t-1}] + \beta_6[(NEG\_CFO * CFO_{it})/A_{i,t-1}] + \varepsilon_{it} \quad (1)$$

Where:

- $TA_{it}$  = Total accruals in year  $t$  for firm  $i$   
 $A_{i,t-1}$  = Total assets in year  $t-1$  for firm  $i$   
 $\Delta Rev_{it}$  = Revenues in year  $t$  less revenues in year  $t-1$  firm  $i$

- $Rec_{it}$  = Receivables in year  $t$  less receivables in year  $t-1$  firm  $i$
- $PPE_{it}$  = Gross property, plant, and equipment in year  $t$  for firm  $i$
- $CFO_{it}$  = Cash flow from operation year  $t$  firm  $i$
- $NEG\_CFO_{i,t}$  = An indicator variable set equal to one if CFO is less than zero, and zero otherwise
- $\epsilon_{it}$  = Error term in year  $t$  for firm  $i$

The absolute values of discretionary accruals as a proxy for accounting conservatism was multiplied by -1 of the absolute values of discretionary accruals (DA) so that higher values of it represents higher accounting conservatism. Next, this research investigated the effect of board size, the proportion of independent director, and audit committee size on accounting conservatism by using equation (2):

$$AC = \alpha_0 + \alpha_1 BS + \alpha_2 IB + \alpha_3 AuC + \epsilon_{it} \tag{2}$$

Where:

- $AC$  = Accounting conservatism
- $BS$  = Board size
- $IB$  = The proportion of independent directors on the board
- $AuC$  = Audit committee size

### Research Results

Descriptive statistics of variables of this research were shown in table 2, and multiple

regression results of the effects of board size, the proportion of independent board, and audit committee size on accounting conservatism were shown in tabel 3.

Table 2 Descriptive statistics of variables

Variables	Min	Max	Mean	Std. deviation	N
$AC$	-5.4214	2.4525	-.0226	0.9965	389
$SB$	4	12	7.42	1.8820	389
$IB$	0.20	0.91	0.4972	0.1270	389
$AuC$	3	6	3.44	0.6960	389

The descriptive statistics of variables showed minimum, maximum, mean, and standard deviation, respectively:  $AC$  were -5.4214, 2.4525, -.0226, and 0.9965, respectively.  $SB$

were 4, 12, 7.42, and 1.8820, respectively whereas  $IB$  were 0.20, 0.91, 0.4972, and 0.1270, respectively, Finally,  $AuC$  were 3, 6, 3.44, and 0.6960, respectively.

Table 3 Multiple regression results of the effects of board size, the proportion of independent board, and audit committee size on accounting conservatism in Malaysia and Singapore

Independent Variables	Exp. sign	Unstandardized coefficients		Standardized coefficients	t-test	p-value	Collinearity statistics	
		B	Std.error	Beta			Tolerance	VIF
(Constant)	None	-0.013	0.227		-0.058	0.954		
<i>SB</i>	(+)	0.058	0.015	0.154	3.850	0.000*	0.861	1.161
<i>IB</i>	(+)	0.571	0.260	0.084	2.195	0.029*	0.939	1.065
<i>AuC</i>	none	-0.214	0.052	-0.165	-4.146	0.000*	0.873	1.146
<i>F</i>				8.343				
<i>p-value</i>				0.000*				
<i>R</i> <sup>2</sup>				0.035				
Adj <i>R</i> <sup>2</sup>				0.030				

\* Significant at a significance level of 0.05

Table 3 showed the results of the multiple regressions model. This model was significant at reliability level of 95% ( $\alpha = 0.05$ )\*, indicating that this model is statistically valid.  $R^2$  of the model was 0.035 meaning that the explanatory variables were able to explain the dependent variable by 3.50%. The multiple regression results indicated positive significant effects of both board size (+0.058) and independence board (+0.571) on accounting conservatism. Thus,  $H_1$  and  $H_2$  were accepted. This research result was consistent with the study of Bradbury, Mak, and Tan (2006) which examined the relationship between abnormal accruals and governance using a sample of firms from Malaysia and Singapore. They found that board size and the proportion of independent director on board were related to lower abnormal working capital accruals, implying high accounting quality (Bradbury et al., 2006). The mean of proportion of independent was 0.4972, which was also in line with the study of Loon and Schacht (2012) indicating that the improvement of board governance in Hong Kong could be

achieved by increasing the proportion of independent non-executive directors to at least 50 percent (Loon & Schacht, 2012). Nevertheless,  $H_3$  was rejected because the result showed the negative relationship between audit committee size (-0.214) and accounting conservatism, so this research argued with the study of Ayemere and Elijah (2015) which found the positive relationship between audit committee size and quality of financial reporting (Ayemere & Elijah, 2015).

## Discussion

The results of this research supported agency theory, which suggests that both board and independent directors are more likely to use accounting conservatism as a tool for reducing agency conflict and facilitating the monitoring process over managers. This is in accordance with the notion that directors who have diverse education and industry backgrounds and skills with multiple perspectives are likely to improve the operations' quality of the firms (Zahra & Pearce, 1989). In addition to the AEC joining of Malaysia and Singapore, leading to changing the business



environment to be more complex, the firms face with the need of strategic team, and it is impossible in practice for a single board or even a small group of individuals board to understand all of the issues (Conger et al., 1998). For the audit committee, it showed the surprising result of the negative relationship between audit committee size and accounting conservatism. However, the previous studies (Hamdan et al., 2012; Kamarudin & Ismail, 2014; Kipkoech, 2016; Kusnadi et al., 2015) confirmed that financial reporting quality depend on attributes of audit committee and are consistent with the suggestion of Sultana (2015), that when the stakeholders judge the committee's value, they should pay greater attention to experience of members, the financial expertise, and meeting frequency of them (Sultana, 2015). The additional supporting report of Kusnadi and colleagues (2015) revealed that the audit committees in listed firms on Singapore Exchange already consisted of a majority of independent directors, so incremental independence of audit committees did not improve quality of financial reporting (Kusnadi et al., 2015). The result of this research can be further explained that expertise and experience of audit committee are sufficient for their effectiveness. There is a possibility that more audit committee size could lead to the problems of communication and coordination and decrease the ability to control management (Jensen, 1993; Yermack, 1996).

### **Limitations and Recommendations for Further Research**

This research was intended to fill this void by attempting to answer the question that in Malaysia and Singapore whether the board of directors and sub-committee, which is audit committee, had the effects on accounting conservatism as well as to investigate whether

they have a positive or negative relationship on accounting conservatism. Nevertheless, this research still had limitations. First of all, this research collected data based on primarily information from the 2018 annual report of the firms from their websites. This information which was publicly available, easily accessible, and understandable was used. Second, the measurement of the accounting conservatism could be done in several ways, but this research used only discretionary accruals to examine the effect on accounting conservatism. Furthermore, this research did not consider the difference of firms in terms of firm size which could also influence the level of accounting conservatism (Abdul-Manaf et al., 2014). Several chances still remain open for future research. For example, the further research may use various proxies for measuring accounting conservatism since board composition effectiveness depends on the measure of conservatism (Yunos, 2011). Moreover, the other business environments of the firms both inside and outside ones could be chosen, and focusing the further research on several years of the annual reports could also be taken into consideration. Last, but not least, Makhlof, Alsufy, and Almubaideen (2018) explained that a diversity of nationality of the board was significantly and positively correlated to accounting conservatism (Makhlof et al., 2018), so the further research should be to find out the effect of the nationality diversity of the board on accounting conservatism of Malaysian and Singaporean listed firms.

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