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## Board Size and Accounting Conservatism of Malaysian Listed Firms

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### ABSTRACT

**Background:** Board of directors is entrusted with responsibilities to monitor operations of firms. Therefore, the board should have effective characteristics to ensure the interest of shareholders is protected. In view of that, Code of Corporate Governance was issued in Malaysia in 2000 to strengthen the board. **Objective:** This paper examines board size, one of the board's characteristics, to assess whether it is big or small board that produces high quality financial reporting. In particular, it examines the effect of board size on the level of accounting conservatism for Malaysian firms listed on Bursa Malaysia. Accounting conservatism is an important element in good quality financial reporting. Sample of this study consists of 3,852 firm-year observations of non-financial firms over the period 2001-2012. **Results:** From the analysis, results reveal that the level of accounting conservatism is higher for firms with small board size. **Conclusion:** With respect to financial reporting quality, board of directors is more effective when the number of board members is small.

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## INTRODUCTION

The central monitoring and controlling system of a firm is the board of director (Fama and Jensen, 1983). It is entrusted with responsibilities to oversee operations of firm and to ensure the interest of shareholders is protected. Corporate governance provides mechanisms for the board of director to govern the operations of firm (Shleifer and Vishny, 1986). In Malaysia, the Code of Corporate Governance was first issued in March 2000. A revised version of the Code was released in 2007 which aims 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 Code has improved the perception of investors towards the standard of corporate governance (KLSE-PricewaterhouseCoopers, 2002). Prior studies in Malaysia that examine board characteristics find that board characteristics affect the quality of financial reporting. Mohd. Salleh, Mohd. Iskandar and Rahmat (2005) report that duality is positively related to earnings management. Duality refers to one person who assumes the roles of CEO (Chief Executive Officer) and Chairman. Abdul Rahman and Mohamed Ali (2006) find that larger board size is not effective as higher earnings management is observed in firms with large board size.

In this paper we extend prior studies to examine the association of board size with accounting conservatism. Accounting conservatism is an important element in good quality financial reporting (Ball, Robin, and Wu, 2003; Beekes, Pope, and Young, 2004; Fan and Wong, 2002). It is argued that accounting conservatism is an effective mechanism for the board of directors to address agency problem (Watt, 2003; Ahmed and Duellman, 2007). Our results show that accounting conservatism is observed in Malaysian listed firms. Furthermore, the results show that there is a difference in the level of accounting conservatism between firms with large board size and firms with small board size. Higher accounting conservatism is observed in firms with small board size. As far as accounting conservatism is concerned, our results suggest that board of director with small number of member monitors better the quality of financial reporting.

The rest of the paper proceeds as follows. Section 2 reviews prior studies and develops the hypothesis. Section 3 discusses the research method and Section 4 presents the results and discussions. Section 5 is the conclusion.

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### ***Literature Review and Hypothesis Development: Malaysian Code of Corporate Governance:***

Malaysian Code of Corporate Governance was first issued in March 2000. The Code essentially aims to encourage disclosure by providing adequate, timely and relevant information to the investing public to facilitate the making of informed investment decisions and to evaluate firms' performance. The Code sets out principles, best practices on structures and processes that firms may use in their operations towards achieving the optimal governance framework. It comprises of four parts, namely principles of corporate governance, best practices in corporate governance, principles and best practices for other corporate participants and the explanatory notes. The principles underlying the Code focus on four areas, including board of directors, director's remuneration, shareholders and accountability and audit. A revised version of the Code was released in 2007. Key amendments to the revised Code are 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 amendments spell out the eligibility criteria for the appointment of directors and the role of the nominating committee.

### ***Accounting conservatism:***

Accounting conservatism recognizes economic losses immediately in the financial statements, but it requires higher verification standards for recognition of economic gains. It is argued that 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 (Ball and Shivakumar, 2005; Watts, 2003). Prior research indicates that accounting conservatism is associated with high quality financial reporting. For example, Beekes *et al.* (2004) find that 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. Ahmed and Duellman (2007) obtain similar results. They report that accounting conservatism is high for firms with high percentage of outside directors' shareholdings. For firms with high percentage of inside directors' shareholdings, accounting conservatism is low. Lara, Osmá and Penalve (2009) report that firms with stronger corporate governance have higher degree of accounting conservatism. LaFond and Roychowdhury (2008) and Cullinan *et al.* (2012) find that accounting conservatism is negatively associated with managerial ownership.

### ***Board size:***

Board size refers to the number of board members. The size of the board is important as it influences the extent to which the board is able to reach consensus and take advantage of the knowledge and expertise of the individuals. Jensen (1993) suggests that a board should have a minimum of seven or eight members to function effectively. However, to date, there is still no consensus over the size of the board that best govern a firm. It is argued that large board is more effective as large board has more external linkage and expertise. Furthermore, large board has more capabilities and resources to solve group tasks (Dalton *et al.*, 1999; Halebian and Finkelstein, 1993; Pierce and Zahra, 1992). On the other hand, another competing view in the literature suggests that small board is more effective than large board as a small number of individuals is likely to agree on a particular outcome (Lange *et al.*, 2000) and to engage in genuine interaction and debate (Firstenberg and Malkiel, 1994). It is also argued that large board is value reducing because large members make coordination, communication and decision making more complicated and, hence, less efficient (Yermack, 1996; Eisenberg, Sundgren and Wells, 1998; Forbes and Miliken, 1999; Gladstein, 1984; Judge and Zeithaml, 1992; Shaw, 1981).

Malaysian Code of Corporate Governance suggests that the number of board members should be appropriately determined for the board to be effective. In Malaysia, studies provide mixed results with regard to the relationship between board size and financial reporting quality. Abdul Rahman and Mohamed Ali (2006) find that earnings management is higher for firms with large board size. On the contrary, Mohd. Saleh *et al.* (2005) report that there is no relationship between earnings management and board size.

In view of that prior studies do not provide conclusive evidence on the effect of board size on financial reporting quality, and that the Malaysian Code of Governance is silent on the number of board members, we do not predict any direction with regard to the relationship between board size and accounting conservatism. Therefore, we hypothesize that there is a relationship between accounting conservatism and board size.

### ***Research Method:***

The sample consists of 3,852 firm-year observations of non-financial firms listed on Bursa Malaysia over the period 2001-2012. Data are retrieved from the Datastream database. To be included in the sample, firms must have available data to compute earnings and stock returns. We exclude observations with missing values.

We use 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:

$$E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + e_t \quad (\text{model 1})$$

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  $e_t$  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 variable for board size to examine the association of board size with accounting conservatism. The estimating equation is as follow:

$$E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \beta_4 \text{SIZE}_t + \beta_5 \text{SIZE}_t D_t + \beta_6 \text{SIZE}_t R_t + \beta_7 \text{SIZE}_t D_t R_t + e_t \quad (\text{model 2})$$

$\text{SIZE}$  represents board size that equals one when the number of board members is above the sample median and equals zero otherwise. The coefficients on  $\text{SIZE} * D * R$  is expected to be statistically significant when the level of accounting conservatism is different between firms with large board size and firms with small board size.

### Results:

Table 1 presents descriptive statistics for variables earnings, stock return and board size. Earnings have mean value of 0.069 and median value of 0.076. The minimum and maximum values for earnings are -0.580 and 0.596, respectively. The mean value for stock return is 0.104 and the median value is 0.019. Stock return has a minimum value of -0.891 and the maximum value of 4.584. The mean for board size is 7.7 and the median is 7. Board size has minimum and maximum members of 4 and 21, respectively.

**Table 1:** Descriptive Statistics.

Variables	Mean	Median	First quartile	Third quartile	Minimum	Maximum
E	0.069	0.076	0.034	0.123	-0.580	0.596
R	0.104	0.019	-0.169	-0.263	-0.891	4.584
SIZE	7.7	7	6	9	4	21

$E$  is annual earnings deflated by the beginning of period market value,  $R$  is a twelve-month stock return measured from eight months prior to the fiscal year through four months after the fiscal year end and  $\text{SIZE}$  is the number of board members.

Table 2 presents results of pooled cross-sectional regressions. In model 1,  $D * R$  captures difference in the sensitivity of earnings to negative stock returns. The coefficient on  $D * R$  is 0.125 and it is positive and statistically significant. The result provides evidence the existence of accounting conservatism. Model 2 includes variable  $\text{SIZE}$  and its interaction with  $D$  and  $R$ .  $\text{SIZE} * D * R$  seeks to capture difference in the level of accounting conservatism between firms with large board size and firms with small board size. The coefficient on  $\text{SIZE} * D * R$  is -0.095 and statistically significant, suggesting that there is a difference in the level of accounting conservatism between firms with large board size and firms with small board size. As the coefficient on  $\text{Size} * D * R$  is negative and statistically significant, it indicates that firms with small board size have higher level of accounting conservatism than firms with large board size. To check the sensitivity of our results, we re-estimate model 1 and model 2 using a fixed effect analysis to control for the effect of time period. We obtain similar results.

**Table 2:** Regression Results for Earnings on Stock Returns and Board Size.

	Model 1a	Model 2b
Intercept	0.078*** (0.000)	0.068*** (0.000)
D	0.004 (0.464)	0.007 (0.415)
R	0.017** (0.013)	0.019 (0.109)
$D * R$	0.125*** (0.000)	0.158*** (0.000)
SIZE		0.016** (0.016)
$\text{SIZE} * D$		-0.010 (0.355)
$\text{SIZE} * R$		-0.002 (0.864)
$\text{SIZE} * D * R$		-0.095** (0.012)

\*\*Significant at 5%, \*\*\*Significant at 1%.

(figures in the parentheses are the p-values)

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

$$b E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \beta_4 SIZE_t + \beta_5 SIZE_t D_t + \beta_6 SIZE_t R_t + \beta_7 SIZE_t D_t R_t + e_t$$

$E_t$  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,  $SIZE$  represents board size that equals one when the number of board members is above the sample median and equals zero otherwise, and  $e_t$  is the residual term.

Overall, we provide evidence that Malaysian listed firms produce high quality financial reporting, and that the quality of financial reporting is affected by board size. It appears that the number of board members is an important factor to influence the quality of financial reporting. Small board size is more effective in monitoring the quality of financial reporting. The results support the view that small board size monitor better the quality of financial reporting (Abdul Rahman and Mohamed Ali, 2006).

### Conclusion:

This study examines accounting conservatism and the effect of board size on the level of accounting conservatism for Malaysian firms listed on Bursa Malaysia. The results obtained from 3,852 firm-year observations over the period 2001-2012 indicate the existence of accounting conservatism, suggesting that Malaysian listed firms produce high quality financial reporting. Furthermore, the results indicate that there is a difference in the level of accounting conservatism between firms with small board size and firms with large board size. Higher accounting conservatism is observed in firms with small board size, suggesting that small board size is more effective in monitoring the quality of financial reporting.

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