

Does Corporate Governance Matter? Evidence from Accounting Conservatism Practices among Jordanian Listed Companies

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Abstract

The problem in accounting conservatism practice has been the focus of everyone. In our view, it was attributed amongst other factors to the weak of corporate governance practices. Such study develops an empirical model on the association between some mechanisms of corporate governance and accounting conservatism in terms of foreign ownership, board independence, board size and audit committee, through choosing Jordanian listed companies as research sample. The data were collected through using the annual reports of 113 Jordanian companies for year 2011. Four hypotheses were developed in this study. Upon using the multiple regression analysis, three of them were significant while one was not. This study concludes that there is a positive and significant association between each of foreign ownership, board independence and audit committee and accounting conservatism. While a negative and insignificant relationship between board size and conservatism. In addition, this study opens up opportunities and provides avenues for more in-depth research related to the accounting conservatism.

Keywords: Accounting conservatism, corporate governance, accrual-based, Jordan

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1. Introduction

Accounting conservatism is deemed as the most effective principle underpinning accounting valuation and has a lengthy historical application to financial accounting exceeding, five centuries (Basu, 1997; Sterling, 1970). Nonetheless, the concept of conservatism faces significant criticism by academics, capital market regulators and standards-setters. Critics such as La Fond and Watts (2008) argued that conservatism leads to understate of net assets in the present period leading to overstate of earnings in the future periods due to the understate of future expenses. Despite heavy criticism, previous empirical studies reported that conservatism has increased during the past decades (Givoly and Hayn, 2002; Lobo & Zhou, 2006). This suggests, critics may overlook major benefits of conservatism. The lengthy persistence and resilience to criticism of accounting conservatism are intriguing empirical impasses producing a number of significant unanswered questions.

Previous studies have defined conservatism by the aphorism “anticipate no profit, but anticipates all losses” (Watts, 2003a). Basu (1997) has defined accounting conservatism as earnings asymmetric timeliness that requires high level of verification for recognizing of good news as an economic profit than recognizing bad news as an economic loss. Givoly and Hayn (2000) have defined accounting conservatism as a choice between the principles of accounting that lead to decrease the cumulative earnings by slower recognition of revenue. All previous definitions have acknowledged that earnings that reported under accounting conservatism practices are understated rather than overstated.

Conservatism practices contribute to accounting field through many facets. Agency theory is the field that received much attention in this aspect, where previous studies have documented that conservatism decreases agency conflict as it limits over payment of incentive to directors (Kwon, Newman & Suh, 2001), permitted for early detection of adverse net present value projects as it promptly recognizes expected losses (Ball, 2001). Additionally, prior studies suggested that conservatism limits the opportunistic behavior of managers (Brown, He & Teitel, 2006; Chen, Hemmer & Zhang, 2007; Watts, 2003a) and decreases information asymmetry among outside shareholders and managers (LaFond & Watts, 2008). Moreover, conservatism is more beneficial in monitoring the cost of suboptimal managerial decisions than if the earnings were measured liberally or neutrally (Kwon, 2005). The usefulness of conservatism in the agency relationship, ultimately enhance the usefulness of financial reports (Ball & Shivakumar, 2006) and improve firm value (Watts, 2003b).

Kung, James and Cheng (2008) reported that conservatism is a significant underlying attribute of reporting quality. Ball and Shivakumar (2005) meanwhile have reported that conservatism is a significant attribute of earnings quality because it makes financial reports more useful and informative. Therefore, stakeholders are better capacity to monitor performance of firm. In addition, Ball, Robin and Wu (2003) believed that conservative accounting practices present more timely information giving creditors and shareholders’ better opportunities to make main decisions on loss making projects.

2. Theoretical Background

Interests' conflicts among corporate directors and other parties to the firms arise due to that the corporate managers control effectively corporate assets while they do not have a significant amount of equity in their companies (Ahmed & Duellman, 2007; Jensen & Meckling, 1976). Some of previous studies have suggested that it's difficult to control and resolve such conflicts through contracts, because it is very costly, if not impossible, to create and impose full contracts (e.g. Fama & Jensen, 1983; Hart, 1995). Therefore, under a world with not complete contracts; the mechanisms of corporate governance have emerged to limit such conflicts. These governance mechanisms differ in terms of their costs and benefits, due to differences with corporate attributes such as the size, leverage, of investment opportunity (Ahmed & Duellman, 2007; Watts, 2006). Based on this disparity also, the task of providing an optimal combination of mechanisms of corporate governance is not easy. Consequently, the current paper focuses on the relationship between foreign ownership, board independence, board size and audit committee.

In addition, previous studies have documented that accounting conservatism contributes an important role in limiting agency conflict (Kwon, Newman & Suh, 2001). As well, conservatism practices can also control the problems of moral hazard arising from agency conflict such as aggressive earnings management (Dea'a, 2014).

3. Research Hypotheses

3.1 The relationship between foreign ownership and accounting conservatism

Previous studies showed that foreign investors in capital markets give prioritize for equity shares of companies with low level of asymmetry information to those with high level (Ball & Shivakumar, 2005; LaFond & Watts, 2008). If foreigner investors were attracted to the firms that have rich information and have a low level of asymmetry, the size of foreign shareholdings should be negatively associated to the level of asymmetry (Anonymous, 1996; Fan & Wong, 2002). LaFond and Watts (2008) showed evidence that there is positive relationship between asymmetry of information among outside and inside investors and the level of conservatism and thus the information asymmetry drives to conservatism. They also showed that conservatism decreases the managers' incentives and their ability to manage and manipulate financial figures. In the bottom line, the issues that generate because of the asymmetry of information between managers shareholders require more employ of financial statements in contracting and communicating, and thus polarization more demand for conservative practices (Ball & Shivakumar, 2005).

Since the financial crisis in Asia in 1997, the weak transparency level in the capital markets of most Asian countries has received great interest from the of global investment society side. It has been reported that the financial disclosures of companies are not transparent sufficiently to assist foreign investors evaluate the timing and amount of expected flow of cash in future (e.g. Ang & Ma, 1999; Ball, Kothari, & Robin, 2000). This insufficient level of transparency leads to increase the level of asymmetric information in such markets, which leads also to increase the capital cost from external suppliers' side.

In this regard, Jordanian government has issued and revised a set of important laws and regulations to increase the level of transparency which helps foreign investors to allocate their investments and expected the future cash flows and thus more confidence of financial reports. These regulations and laws such as Privatization Law No. 25 of the year (2000), Banks Law in (2000) and Corporate Governance Code (2009) have been issued in order to encourage and attract the investment by non-Jordanians and to insure a high level of earning quality through adopting a higher level of conservatism (Faudziah, Dea'a & Ismail, 2014; Hamdan, 2011; Hamdan, 2012a; Zureigat, 2011). Therefore, this paper employs foreign ownership to show an important aspect of Jordanian ownership structure that interprets the Jordanian business environment. In conclusion, agency theory reported that foreign ownership enhances quality of financial statements through conservatism practices. Therefore, the following hypothesis is suggested as follows:

H1: There is a positive relationship between foreign ownership and accounting conservatism.

3.2 The relationship between board characteristics and accounting conservatism

Board of directors plays a vital role in the governance of large institutions (Lanfranconi & Robertson, 2002). Boards also help control and monitor the senior directors' behaviour, thereby protecting the shareholder's interests. Lara, Osma, and Penalva (2007) and Rodriguez (2010) suggested that the existence of independent directors on the corporate board help to ensure independence of corporate board from the management. In addition, independent directors can contribute to solving the disagreements between the internal managers or between the residual claimants and internal managers. Thus, boards comprising independent managers will give a counterbalance so that the insider managers do not take advantage of their position and sacrifice the wealth of shareholders. Pfeffer and Salancik (2003) showed that the existence of independent directors would enhance the flow of data, and hence protect the company resources and decrease uncertainty.

A growing related literature have documented that the transparency and information asymmetry of firms influence characteristics of its board structure in general, and the percentage of independence directors in particular (Armstrong, Core & Guay, 2014). Previous studies argued that independent directors find it difficult in monitoring and advising roles particularly when the processing costs, information transfer and asymmetry of information are high, and thus that companies with high level of asymmetry of information choose to have low level of independent directors (e.g., Linck, Netter & Yang, 2008; Lehn, Patro & Zhao, 2009). Previous studies such as Pfeffer (1972) and Ellstrand (1999) have used resource dependence theory to examine boards focus on board composition and its size as indicators of the ability of boards to provide important resources to the corporate. Pfeffer (1972) for instance, reported that board size relates to the corporate environmental needs and those with more correlation require a higher level of outside directors. Therefore, this study assumes:

H2: There is a positive relationship between board independence and accounting conservatism.

As for board size, there are mixed views about the role of board size in the literature. Agoraki,

Delis and Staikouras (2010) concluded that larger size of boards is less effective than smaller size of boards due to difficulties in coordination of task. Lasfer (2004) reported also that the directors on a large board are less likely to criticize the policies of top management, hence are subject to the control of CEO. Further, large board tends to employ less meaningful discussion since too many directors attended in the discussion, making it need more time and effort to achieve cohesiveness. Further, a large board is less effective due to the slowdown in decision making, and one member will depend on other members to monitor management. As well, Hermalin and Weisbach (2003) Bhagat and Black (2000) showed that large boards are less involved in strategic decision-making.

On the other hand, Dalton and Dalton (2005) suggested that a large size of board provides a wider range of expertise and knowledge. This finding is partly supported by Akhtaruddin, Hossain and Yao (2009) through their results that found a positive relationship between size of board and voluntary disclosure. Based on this view, the current paper suggests the following hypothesis:

H3: There is a positive relationship between large board size and accounting conservatism.

3.3 The relationship between Audit committee and accounting conservatism

Audit committee is considered as the indicator to state whether the presence an audit committee adds more credibility to the financial data issued by a company (Abbott & Parker, 2000; Bedard, Chtourou & Courteau, 2004; Klein, 2002). Previous literatures have determined three regulatory responsibilities of audit committee (e.g., monitoring the external audit function, ensuring the impartiality of the financial reports and scrutinizing the process of internal audit), then the audit committee will be deemed as effective (DeZoort, Hermanson & Archambeault, 2002; Vera-Munoz 2005).

Audit committee did not receive much attention by researchers and regulators, despite the important role of audit committees in various fields (Collier & Gregory, 2000; Abdullatif, 2010). The collapse of the largest firm, Enron Corporation, in the U.S. history in 2001 urged superior firm accountability from investors and regulators alike. Consequently, the U.S. Congress established a new legislation known as the Sarbanes-Oxley Act that mandates all public companies to set up audit committees. The Act also stipulates the audit committees responsibilities and composition (Congress of the United States of America, 2002). Shortly after, other nations like Canada, the U.K. and Australia also acknowledged the audit committee's oversight responsibilities in similar terms as stipulated in SOX. The established regulatory bodies in the above countries are the LSE, the Toronto Stock Exchange, British Financial Reporting Council, Canadian Securities Administrators and the ASX.

In Jordan, the Corporate Governance Code for shareholding corporate listed under the ASE has identified the duties of the audit committee that holds the task of monitoring and overseeing accounting and auditing activities in the firm (ASE, 2009). Gay and Simnett (2007) have defined the audit committee as directors' committee responsible for liaising with the internal and external audit functions and overseeing external financial reporting. The audit

committee performs many of the main functions; while the main responsibility of the audit committee is to supervise and manage the process of financial reporting (Klein, 2002). In practice, Nimer, Warrad and Khuraisat (2012) found that the performance of the audit committees in Jordanian listed firms seem to be poor and ineffective due to the constraints on audit committees' members' work and also the weak independence of their members as their results have shown. They also showed that most of the audit committees' members have close relationships with the members of board of directors and the top management of the firms. As well, Abu-Haija (2012) found that the presence of audit committee negatively correlated with the manipulation in financial reports in Jordan, and he concluded that 51.7% of Jordanian listed firms don't have an audit committee.

This study employs audit committee because it's considered as a key institution in the context of corporate governance, as well helps the boards to fulfil their fiduciary and financial responsibilities to shareholders. Therefore, it can be hypothesized that:

H4: There is a positive relationship between the existence of audit committee and accounting conservatism.

4. Sample and Data

This study examines all industrial and services firms listed under ASE, for the year 2011. The total number of these firms in 2011 is 130 firms. 17 firms are excluded from the current study due to insufficient disclosure for the necessary data. Accordingly, remaining is 113 firms. In addition, all firms under the financial sector are also excluded because they are subjected to additional rules and requirements. For the analysis purposes, all secondary data are hand-collected from the annual reports of firms.

5. Research model and variables measurement

- Accounting Conservatism: this study uses the accrual-based measure as developed by (Givoly & Hayn, 2000) to measure accounting conservatism. There has not been a detected in the literature on any possible a bias in this measure, as well as this measurement is more sophisticated than other measurements (Wang, 2009). The simple form is shown as follows:

$$Accruals = \frac{Income + DepreciationExpenses - OperatingCashflows}{TotalAssets}$$

$$ACCR = \frac{Accruals}{3\ years} * (-1)$$

- Foreign Ownership: is considered an additional dimension because of its importance in Jordanian environment as an emerging market. Based on the

previous studies, foreign ownership was computed as the shares' percentage held by foreigners to total number of shares (Ali, Salleh & Hassan, 2008; Klai & Omri, 2011).

- Board Independence: was computed as the number of outside directors as a proportion of board size (Hayes, Mehran & Schaefer, 2004; Klein, 1998).
- Board Size: measured using the total number of board members (Ahmed and Duellman, 2007).
- Audit Committee: was computed by the presence of audit committee in the firm, coded 1 if there is an audit committee in the firm and coded 0 otherwise (Goodwin & Seow, 2002; Gulzar & Wang, 2011).

Consequently, the current regression model employs to test the association between foreign ownership, board independence, board size and audit committee and accounting conservatism is as follows:

$$ACCR_{it} = \beta_0 + \beta_1 FORE_{it} + \beta_2 BIND_{it} + \beta_3 BSIZ_{it} + \beta_4 AC_{it} + \varepsilon_{it}$$

Where

Table I: Variables Definition

Symbols	Variables Definition and Measurement
ACCR	Accrual-based measure of accounting conservatism = [(income + depreciation expenses – operating cash flows)] ÷ Total assets. ACCR = (Accruals / 3 years) X (-1).
FORE	Foreign ownership: measured as the percentage of shares held by foreigners to total number of firm's shares.
BIND	Board independence measured proportion of independent directors to total directors on board.
BSIZ	Board size is the natural logarithm of total number of board members.
AC	Audit Committee measured as dummy variable = 1 if firm has audit committee and 0 otherwise.

6. Empirical Analysis

6.1 Analysis of Whole Sample

Table II gives the descriptive statistics of sample data for 113 companies that meet the required data for year 2011. The mean value of the ACCR is -.0051. This average is almost lower than the mean value of accrual conservatism at 0.010 and -.004 that documented by Ahmed and Duellman (2007) and Ahmed, Billings, Morton and Stanford-Hars (2002) respectively.

The mean value of foreign ownership (OWFORE) is 41.5% with a maximum value of 77%. Such result indicates that approximately half of Jordanian firms' shares are owned by non-Jordanian (foreigners), which may give them the opportunity to control and monitor these firms closely in the future and take part in decision-making (Zureigat, 2011).

As for the independence of board members (BIND), the mean value is 65.26%. This value refers that more than half of Jordanian firms had complied with the requirements of Jordanian code of corporate governance to have an independent directors in their boards to assure the availability of objective decisions. On the other hand, the average board size (BSIZ) is 9.61 members with a standard deviation of 1.466 are compatible with Lipton and Lorsch (1992) who suggested that the members of boards should be ten people, and they preferred size of eight or nine.

Table II also shows that the average of Jordanian firms that have audit committee (AC) was 55%. Our result suggests that there is a lack of commitment in applying the requirements of governance code that require companies to establish an audit committee, where 51 or 45% of Jordanian companies did not have an audit committee. This result is almost similar to the result of Dea'a (2014) who found that 44% of Jordanian firms did not have an audit committee.

Table II: Descriptive Statistics of Variables

Variables	Minimum	Maximum	Mean	Std. Deviation
ACCRU	-.30	.30	-.0051	.10429
FORE	.08	.77	.4147	.13145
BIND	.27	1.00	.6526	.16990
BSIZ	6	13	9.61	1.466
AC	0	1	.55	.458

Note: See Table I for variables definition

6.2 Correlation Analysis

Table III demonstrates the correlations coefficients among dependent and independent variables. The coefficients for foreign ownership, board independence and audit committee are consistent with our expectation that they lead to better governance and employed higher conservatism. On the other hand, the negative coefficient of board size is not consistent with our expectation; this result is supported by the previous studies which concluded that larger size of boards is less effective than smaller size of boards due to difficulties in coordination of task (Agoraki, Delis & Staikouras, 2010).

The correlation coefficient among foreign ownership and board independence and board size is negative, while a positive coefficient is exists among foreign ownership and audit committee. Board independence has a positive correlation with board size and negative with audit committee. Table III also shows a negative correlation among board size and audit committee.

Table III: Pearson correlation coefficients among variables

	ACCRU	FORE	BIND	BSIZ	AC
ACCRU	1				
FORE	.175	1			
BIND	.001	-.174	1		
BSIZ	-.201*	-.126	.135	1	
AC	.497**	.058	-.315**	-.182	1

6.3 Hypotheses Testing

Before the regression analyses and hypotheses testing are performed, the assumptions that related to the multiple regression analyses are checked. These assumptions are outliers, normality, linearity, multicollinearity, autocorrelation and homoscedasticity (Coakes & Steed, 2003; Hair, Black, Babin, Anderson and Latham, 2010). The results concluded that there is no violation of these assumptions.

Table III shows that the model is significant ($F= 12.573$) (Sig $F= 0.00$). The model explained 29.2% of the variation in the accrual conservatism (Adjusted $R^2 = 29.2\%$). This adjusted R^2 is higher than the R^2 that reported by Shuto and Takada (2010) and Ahmed and Duellman (2007) at 14% and 12.96% respectively. The following section provides the results of the relationship among the variables under study as hypothesised previously.

Regarding to the foreign ownership, Table III shows that there is a consistent between our prediction and our actual results. The result illustrates a positive significant relationship among foreign ownership and accrual conservatism ($T=2.061$; $P= 0.042$). Our finding is consistent with Mohandi and Odeh (2010) who concluded that firms with higher proportion of foreign ownership contribute positively in improving the quality of financial reports in Jordan. Therefore, hypothesis H1 is supported.

In a similar vein, the results show a positive and significant relationship between board independent and accrual conservatism ($T=2.509$; $P=.014$). This finding is supported by Pfeffer and Salancik (2003) who concluded that independent directors on the boards could protect the resources of corporate and decrease uncertainty level which could promote the flow of information among the corporate and outside parties. Hence, hypothesis H2 is supported.

Table III: OLS Regression Results

Variable	B	Std. Error	Beta	T	P value
FORE	.133	.064	.167	2.061	.042
BIND	.131	.052	.213	2.509	.014
BSIZ	-.008	.006	-.112	-1.370	.174
AC	.122	.019	.534	6.309	.000
DV	= ACCRU				
R ²	= 0.318				
Adj R ²	= 0.292				
F Ratio	= 12.573				
Sig F	= 0.000				
N	= 113				

Unexpected relationship between board size and conservatism is revealed through the results of this paper. The results show a negative and not significant relationship between large board size and accrual conservatism (T= -1.370; P=.174). Lipton and Lorsch (1992) concluded that large size of boards slows decision making as well each member on the board might depend on others to monitor and control management due to the difficulties in coordination of tasks. In U.S, Ahmed and Duellman (2007) reported that the relationship between board size and conservative accounting was not significant. Thus, hypothesis H3 is not supported.

Table III illustrates that there is a positive direction between the presence of an audit committees and accruals conservatism, as well as significant at 5% (T =6.309; P =.000). This finding is supported by agency theory which states that the presence of audit committee improve the financial reporting quality. As well, Abu-Haija (2012) reported that the presence of audit committee limits the manipulation in financial reports among Jordanian firms. Therefore, hypothesis H4 is accepted.

7. Conclusions

Positive accounting theory stated that the corporate with good governance structure use more conservative practices (Pourkazemi & Abdoli, 2011). The outcome of this study seeks to fill the gap on the literature of corporate governance and provide more evidence whether the

same instrument can be employed in emerging economies like Jordan.

This study also profited from the recommendations of the previous studies to pay more attention on the role of foreign ownership to boost demand on conservatism practices (Faudziah et al., 2014; Smith, Ismail & Ahmad, 2011). In addition, this study contributes also by employing accrual-based as a proxy for accounting conservatism, since some of previous studies such as Wang (2009) have documented that there are only nine studies in the accounting literature have used accrual-based to measure accounting conservatism.

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