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Coporate Governance Mechanisms and Accounting Conservatism

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Abstract

The separation of ownership from management and the existence of creditors results in information asymmetry among stakeholders to the firm. Management may pursue interest different from that of other stakeholders; hence, the demand for conservative reporting. This study examines the effects of corporate governance mechanisms on accounting conservatism in the Nigeria food and beverages sector. This study focuses on CEO duality, board size, board composition and managerial shareholding as proxies for corporate governance mechanisms. The negative accrual measure of conservatism was employed in estimating conservatism. Data for the study was obtained from the Nigerian Stock Exchange Fact Book and the companies' annual report for the period 2003 to 2010. The extent of the influence of our corporate governance proxies was estimated using regression method of analysis. Our result reveals a significant negative influence of board size and a significant positive influence of independent directors on the board on conservative reporting. Therefore, we recommend that boards of listed food and beverages firms should be composed more of independent directors. Also, smaller board sizes should be adopted by Nigeria food and beverages firms in other to improve realization of accounting numbers.

Keywords: Corporate Governance, Board of Directors, Accounting Conservatism

Introduction

The world has witnessed the collapse of multinational companies which includes: Enron, World com., Parmalat, among others. Corporate failure mostly arises from poor corporate governance practices. Recent studies have shown that large companies that have failed or filed bankruptcy have perpetrated earnings smoothing years prior to their failures (Abdelghany, 2005 cited in Bello, 2011).

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Also, where management compensation is tied to performance, managers may employ aggressive accounting to increase their rewards which will increase bankruptcy risk in firms. Therefore poor corporate governance can be argued as a factor that influences income smoothing practices in firms.

Application of discretion in the treatment of specific transactions can lead to aggressive accounting, conservative accounting. Aggressive accounting makes accounting numbers to be unreliable has the reported earnings will significantly differ from the operating cash flow; hence accounting numbers may not be realizable thereby increasing bankruptcy risk. The board of directors can be used to enforce discipline on the management by ensuring conservative accounting practices (Garcia, Beatriz & Penalva 2007).

Accounting conservatism is an important attribute of high reporting quality as it is often used to asses the quality of a company's accounting report (Jingling and Changjiang 2008). It is the oldest and most salient characteristics of accounting information for centuries which states that possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets. This principle has influenced accounting practice for at least five hundred years and it is the most influential principle of accounting (Basu, 1997).

Conservatism is a fundamental feature of quality financial statements because it enhances the reliability of financial statements by facilitating effective monitoring of managers and contracts as part of corporate governance mechanisms (Watts, 2003; Ball and Shivakumar, 2005; Basu, 2005). Given that conservatism entails timely recognition of losses than earnings and avoids over estimation of firms value, it therefore reduces bankruptcy risk in firms (Wang, 2009)

Advocates of conservatism posit that it benefits the users of financial reports, as it increases firm value by constraining management's opportunistic payments to themselves or other parties which will ultimately be shared among all parties to the firm, increasing their welfare (Garcia, Beatriz & Penalva 2009). Conservatism is beneficial for creditors, minority stockholders, the firm as a whole and regulatory authorities (Watts, 2003; Ahmed & Duellman 2007; Zhang 2008). Recent researches has shown relationship between sound corporate governance mechanisms and accounting practice, with stronger corporate governance structures improving the implementation of conservative accounting policies (Ahmed & Duellman, 2007; García et. al, 2009).

Despite ample evidence in recent researches on the impact of corporate governance mechanisms on accounting conservatism, there has been little or no evidence in Nigeria; this is an attempt to fill the gap.

The objectives of this study is to investigate the effect of corporate governance mechanisms (CEO duality, board size, board composition, director shareholding) on conservative accounting practice in the Nigerian food and beverages sector. In line with the above, we provide the following statement of hypotheses:

Ho_1: there is no significant positive relationship between CEO duality and accounting conservatism in Nigeria listed food and beverages firms.
Ho_2: there is a no significant relationship between board size and accounting conservatism in Nigeria listed food and beverages firms.
Ho_3: There is no significant relationship between board composition and accounting conservatism in Nigeria listed food and beverages firms.
Ho_4: There is no significant positive relationship between managerial shareholding and accounting conservatism in Nigeria listed food and beverages firms.

The study is seeks to document evidence on the outcome of prior studies that accounting conservatism is influenced by sound governance mechanisms to control moral hazards resulting from agency conflict (Garcia et. al 2009, Rahimah 2011). Lack of prior literature in Nigeria motivates this study to provide Nigerian evidence. This study will be beneficial to the Nigerian Financial Reporting Council (NFRSC), Researchers, academicians and accountants in practice.

2.0 Literature Review Theoretical Framework

Conservatism has traditionally been a fundamental characteristic of financial reporting (Sterling, 1967 cited in Sanjay, 2010). Empirical evidence shows a linkage between accounting conservatism and financial reporting quality. Young (2005) found that accounting earnings becomes more useful for reducing distortion in incentive contracts when measured conservatively than when measured aggressively. He concluded that accounting conservatism enhances the incentive value of accounting signals with respects the cost of agency.

Given that conservatism increases firm value by reducing agency and litigations costs, it is commonly considered as an indicator of earnings quality or a desirable property of accounting earnings (Watts, 2003; Ball and Shivakumar, 2005 cited in Garcia, Beatriz & Penalva 2007). Therefore, in other to reduce managers' opportunistic behavior, owners require timely recognition of losses than for earnings.

Qintao and Xiaho (2006) shows that when firm can control the quality of financial information through non contractible action, an accounting policy that aggregates raw information in a biased fashion can increase the quality of financial reporting. The study takes into consideration the endogenous nature of the information generation process. That is, accounting system that functions as a classification system in the presence of uncertainty serves not only as an aggregation scheme ex post but also incites firms to improve the information quality ex ante. This result only holds if the objectives of standard setting include other consideration such as enhancing corporate control or facilitating litigation. However their study relies on the assumption that the average preference of investors can be captured by the behaviour of representative investor and also they do not study the general setting where different types of investors intend different uses of the same information.

Sanjay (2010) carried out the empirical examination of the positive accounting theory as opined by watts and Zimmerman, (1986). They empirically test the framework for the agency cost related to debt contracts as a specific setting that isolates the demand for accounting conservatism in financial reporting. It was concluded that a contract with a conservative bias is considered more effective. In other words, agency costs associated with debt contracts results in higher demand for conservative information. That is, accounting conservatism is a desirable qualitative characteristic of financial reporting because it is a cost effective mechanism. Their result holds after controlling for other incentives for conservative reporting.

2.1 Accounting Conservatism and Board of Directors Characteristics

There exists empirical evidence on the relationship between board characteristics and accounting conservatism. Nor & Zhu (2011) using a 826 firm-year observation comprising large listed firms in Malaysia reported that board size, audit quality and management ownership results in lower level of conservatism. Contrary to their findings, Wuchun, Chiawen, and Taychang (2007) carried out his study on Taiwan listed firms, he found that inside ownership and CEO duality increases the level of conservatism in sample firms.

In a cross sectional study, Joo (2009) reported more conservative firms operate with less inside ownership and small board size. On the contrary, Garcia, Beatriz & Fernando (2005), investigate whether firms with sound corporate governance shows higher degree of conservatism than weak firms. They control for the endogenous nature of corporate governance and the fact that governance and conservatism may be simultaneously determined using a composite measure that incorporates the level of antitakeover protection and the level of CEO involvement and internal governance. Using a large sample of U.S firms during the period, they found that firms with stronger corporate governance provisions in place are more conservative. Their result is similar even after isolating the event that resulted in exogenous shock to corporate governance and the passage of the Sarbanes Oxley Act of 2002. They also observed causality from strong governance structures to conservatism and not vice versa. That is, strong corporate governance employs conservatism as a tool to fulfill its monitoring role. Their study is limited by the aggregation of governance structures across firms.

Garcia et. al (2007), investigates this relationship in the Spanish context by utilising 69 non-financial Spanish firms from 1997 to 2002. They use a more extensive measure of corporate governance by aggregating the index incorporating the following board characteristics which are directors' denominations, board size, proportion of non-executive directors, independent directors, number of board meetings, CEO/Chairman duality, the existence of audit committee and the existence of a nomination/remuneration committee. They provide evidence which shows that firms with strong boards use conservative accounting numbers as a governance tool even in an institutional setting with low litigation risk. Similar to their U.S study, their research is limited by the aggregation of governance structures across firms.

Donglin and Song (2009) investigate the determinants of accounting conservatism using accrual based measure and data from 2001 to 2006 in china. They found that a higher degree of leverage, low level of control of ultimate shareholders, and low level of management ownership lead to conservative reporting. They provide evidence in support of their argument that management incentives to comply with standards significantly influence the level of conservative accounting reporting. The findings provided reveal that board independence does not have any significant effect on conservative accounting.

However, their study failed to solve endogeneity problem which is always a concern in corporate governance and often ignored in accounting conservatism research. Researches on the existence of conservatism and those that explored the contributory effect of board characteristics on accounting conservatism are discussed bellow.

2.1.1CEO Duality and Accounting Conservatism

There are two views expressed by competing theories. While agency theory posits that CEO and the chairman roles be separated since the board responsibilities includes monitoring the management and the CEO, the stewardship theory views it otherwise. It argues that the CEO acting as the chairman improves performance as there is no information breakdown between the CEO and the board.

Dechow et al., (1995); A Klein (2002) and Muniady (2007) cited in Rahimah (2011) found that joint leadership structure weakened firms governance, as it lead to earnings manipulation and higher fees. Ahmed and Duellman (2007) in a U.S study found no significant relationship between CEO/Chairmanship separation and accounting conservatism. Also, Rahimah (2011) studied the same relationship in the Malaysian context. The study utilized panel data on Malaysian data over seven years from 2001 to 2007, the result shows no evidence that CEO duality is associated with conservatism. In contrast to this, Wuchun et. al (2007) found that firms with CEO acting as the chairman have a greater demand for accounting conservatism to make up for the weakness in sound corporate governance.

2.1.2 Board Size and Accounting Conservatism

Arguments in relation to large or small size of the board exist. In favour of small board size is that directors rarely criticize the policies of top managers and that this problem tend to increase with the number of directors (Yermack 1996, Limpton and Lorsch 1992 cited in Sanda, Mikail, & Garba 2004).

In favour of larger boards is that they may be more constructive as they have more external linkage and the ability to extract critical resources such as funding and expertise, which leads to higher performance (Pearce & Zahra, 1992; Pfeffer, 1987 cited in Joo, 2009).

Joo (2009) found that board size is negatively associated with accounting conservatism while the Rahimah (2011) provides evidence which shows board size is positively associated with conservative accounting. However in a study by Nor, Kamran and Xu (2011), they provide evidence that board size is not related to accounting conservatism in Malaysia.

2.1.3 Board Composition and Accounting Conservatism

The composition of the board can be used as a tool for monitoring and alleviating the opportunistic behaviour of managers. In other words, boards that are mostly constituted of inside directors may lead to transfer of wealth to themselves instead of stakeholders. In a US study, Ahmed and Duellman (2007) found that high proportions of independent directors were associated with high level of accounting conservatism. Also, they found that boards dominated by management is not effective to reduce agency conflict and thus does not employ more conservatism. Garcia et. al (2007) a using aggregate index as a proxy for strong boards found a positive relationship between outside directors and accounting conservatism. They reported that strong boards of directors incorporate bad news significantly faster into earnings than weak boards. That is, accounting conservatism is utilized by independent directors to assist them in monitoring management.

2.1.4 Managerial Shareholding and Accounting Conservatism

Evidence on the use of insider shareholding in solving agency problem is mixed. Douglin & Song (2009) argued that management may manipulate earnings by choosing a reporting method that will maximize their own interest. This will lead to less conservative reporting, especially when the level of management ownership is higher and compensation is more closely related to performance. Their argument is supported with the outcome of their findings which shows a significant negative relationship between managerial ownership and accounting conservatism.

On the contrary, Joo (2009) supports the view that management owning shares in the firm may reduce the agency conflict, thereby aligning their interest with that of the shareholders. Using a sample of 716 malaysian firms, he found that insider shareholding reduces the level of accounting conservatism in firms.

Their result was contrary from their expectation that managerial ownership will improve reliability of financial reporting. Rahimah (2011) obtained similar result which show inside ownership is negatively related to accounting conservatism.

2.2 Control Variables

We control for leverage, firm size and sales growth in determining the effect of board characteristics on conservatism. Firms with high leverage are likely to have higher greater bondholder and shareholder conflict which may affect conservatism (Duellman, 2006 cited in Joo 2009). That is, highly leveraged firms experience more bondholder and shareholder conflicts which increases agency cost. Also, management of highly leveraged firms may engage in earnings accounting to avoid violation of debt contract.

In line with positive accounting theory, larger firms are more conservative in other to avoid political cost (Watts and Zimmerman, 1986). Also, sales growth affects inventories and receivables which could affect accrual measure of conservatism (Ahmed and Duellman, 2007)

According to the agency theory, the separation between ownership and management, and existence of creditors gives rise to agency conflict and information asymmetry among them leads to asymmetric loss function, which induces conservative accounting (Jensen and Meckling 1976, Lafond and watts, 2008 cited in Donglin & Song 2009). These conflicts becomes manifest in different ways, including manipulation of financial information, accounting frauds and expropriation of wealth.

Positive accounting suggests conservative accounting as a useful tool to reduce agency conflict (Rahimah 2011). It facilitates mitigating manager's opportunistic behavior by requiring higher verification for recognition of gains and timely rejection of projects with negative Net Present Value (Duellman, 2004). That is sound corporate governance influence conservative reporting to reduce management opportunistic behaviour. Therefore Agency theory and Positive accounting theory provides a complete framework for describing the link between the characteristics of the board and conservative reporting.

3.0 Research Methodology

The purpose of this study is to examine the effects of board of directors' characteristics on conservative accounting reporting. We therefore employ a descriptive and correlational research design using panel data.

3.1 Population and Sampling.

The population of this study comprises of all food and beverages firms listed on the Nigerian stock exchange within the period of 2003 to 2010. According to the 2011 factbook of the Nigerian stock exchange, sixteen firms were listed under the food, beverages and tobacco sector. Our criteria for the study includes that the company must be quoted and its shares constantly traded during the period on the Nigerian stock exchange. Also, all firms that are newly listed or delisted during the study period were excluded. Only five firms satisfy our criteria and the study therefore employs census strategy.

The data for this study are purely secondary data derived from the annual reports of sampled firms obtained online. We utilize the multiple regression analysis in estimating the hypothesis of the study.

3.2 Measurement of Variables

3.2.1Accounting Conservatism

Our study investigates board of director's characteristics on accounting conservatism. The focus of this study is total conservatism reported by listed firms not conditional or unconditional conservatism. According to Garcia et. al (2005), Givoly and Hayn (2000) developed accrual measure of total conservatism called the negative accrual measure which is firm specific. They argued that a firm experiencing a period of higher (lower) net income compared to cash flow from operations will be expected to have negative (positive) accruals in the following period. They posited that a constant predominance of negative accruals over a long period indicates conservatism. While the rate of accumulation of net negative accruals indicates change in the degree of conservatism over time.

Going by the fact that a firm specific measure of accounting conservatism is required in this study, we therefore adopt the accrual measure by Givoly and Hayn. In line with Rahimah (2011), Joo, (2009) and Duellman (2004), Our measure for estimating conservatism called CON ACCRUAL is:

Accruals*3 years* = [(INC + DEPRN – OCF)] / TA

CONACCR = (Accruals / 3 years) X (-1)

Where

Income = Income before tax and extraordinary items
DEPRN = Depreciation Charge for the year
OCF = Operating Cash Flow
TA = Total Assets

This measure is; profit before extraordinary item less cash flow from operations plus depreciation expense deflated by average total assets, and averaged over a period of three years centered on year t multiplied by negative one. Therefore positive CON ACCRUAL indicate higher conservatism. The intuition underlying this measure is that conservative accounting results in persistently negative accruals also averaging over a number of years ensures that the effects of large accruals are mitigated, as accruals tend to reverse in one or two period (Richardson et. al 2004, Givoly and Hayn 2000 cited in Duellman 2004).

3.2.2 Board of Directors Characteristics

(1) C.E.O/Chairman Separation: this is measured using a dummy variable of 1 if the C.E.O is not the chairman and 0 otherwise.
(2) Board Size: is proxied as the total number of directors serving on the board.
(3) Board Composition: is measured as the percentage of outside directors (i.e. directors with no shareholding and portfolio serving on the board) to the total number of directors.
(4) Director Shareholding: is the total no of shares held by directors serving on the board as a percentage of the total no of issued shares of the company.

Control Variable:

(5) Leverage: Our measure for leverage is natural logarithm of total long term liabilities.

While the model for testing our hypotheses relating the effect of board of directors' characteristics on accounting conservatism is arrived at, thus:

CON ACC = F(BCH)…………………………………..(1)

CON ACC = F(CEO, BS, BC, DS)……………………………………….(2)

Transforming 1 above to linear relation we have

CON ACC*it* = *a0 + β1 CEOit+ β2 BSit + β3* BC*it + β4* *DSit*+ *β4LEVit*+ *Eit………………………………(3)*

Where: CON ACC = Conservatism measure based on Givoly and Hayn (2000) in line with Rahimah (2011), Joo (2009) & Duellman (2004).

4.O Results and Discussion

This table shows the result of our regression of the model relating board characteristics and Accrual measurement of conservatism.

Table 1: Regression Results of CON ACC and Board Characteristics'

Independent Variable	Coefficient	t-stat	Sig	TV	VIF
CEO Duality	.011	.094	.926	.977	1.023
Board Size	-.290	-1.908	.067	.608	1.645
Board Composition	.369	2.710	.012	.757	1.321
Directors Ownership	.140	1.100	.281	.870	1.150
Leverage	.693	4.877	.000	.693	1.442
Total Assets	-.327	-2.000	.056	.524	1.909
Change in Sales	.246	1.916	.066	.851	1.176
R	.789				
R-Square	.622				
Adjusted R-Square	.524				
F Value	6.347		.000		

*significant at 0.1 (2-tailed) **significant at 0.05 (2-tailed) ***significant at 0.01 (2-tailed)

Source: Authors computation using SPSS

Discussion

Although not significant, the coefficient for CEO Chairmanship Separation is positive as expected. The strength of this relationship is not strong enough to suggest that accounting conservatism is associated with conservative reporting. Our result provides evidence in Joo (2009) and Rahimah (2011) and contradicts the findings of Duellman, (2007), Garcia et. al. (2009). We therefore fail to accept our first hypothesis which states that there is no significant positive relationship between CEO, Chairman Separation and accounting conservatism.

The result in the table also shows that board size is negatively related with conservatism which is significant at 1%. This finding suggests that firms having larger board size tend to be less conservative. Our finding is consistent with the findings of Joo (2009), and contradicts Rahimah (2011). Our result supports the findings of Yermack, (1996) and Limpton and Lorsch (1992) cited in Sanda, Mikailu. Garba. T (2004) that smaller boards are more effective boards than larger boards.

Consistent with the expectation that the percentage of independent directors is positively related with accounting conservatism, the result shows a positive coefficient of outside Director which is significant at 5% level of significance. This shows that stronger governance is related to higher conservatism.

Our result is in line with the findings Duellman (2007) and Rahimah (2011) but contrasts the evidence provided Joo (2009), and Donglin and Song (2009). This finding imply that higher number of inside directors in a board (a proxy of weak governance) may relate to lower demand of conservative reporting found by Ahmed and Duellman (2007).

As regards our fourth hypothesis, the result shows a positive relationship between managerial ownership and conservatism although not significant. Also, we fail to reject the fourth hypothesis which states that director ownership does not have any significant effect on conservative accounting. This implies that insider ownership does not really solve agency problem in relation to realisation of accounting numbers. Our findings support that of Joo (2009) and contradict the work of Rahimah (2011).

The explanatory power of the surrogates for board of directors' characteristics on accounting conservatism of quoted food and beverages is 62.2%. That is, board of directors' characteristics explains the changes in accounting conservatism up to 62.2%. Also taking into consideration the firms independent variables, the explanatory variables explain accounting conservatism up to 52.4%. The model for the study is fitted given F. static of 6.347 which itself is significant at 1%. Our tests for multicollinearity which relies on tolerance value and variance inflation factor confirms absence of significant multicollinearity. This further gives evidence on the fitness of the model.

In overall we provide evidence which shows that sound corporate governance practices in particular reference to the board of directors as a governance tool increase the quality of financial reporting in terms of accounting conservatism. This means firms with sound corporate governance practices in relation to board of directors require timelier information for the recognition of bad news than good news.

Therefore, we recommend that boards of listed food and beverages firms should be composed more of independent directors. Also, smaller board sizes should be adopted by Nigeria food and beverages firms in other to improve realization of accounting numbers.

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Appendix

List of Sampled Firms
7up
Flour Mills
Nestle
Cadbury
UTC