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A Manifestation of Accounting Conservatism: A Case Study in Malaysia

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Abstract

In the wake of several high-profile corporate accounting scandals, there has been evidence that companies are more eager to hire Chief Executive Officers (CEOs) with an accounting background. This signals that CEOs with an accounting background are recognized and trusted by the corporate world to boost the quality of financial reporting of a company. If it is so, in the context of combating the earnings management, hiring CEOs with an accounting background (being a conservative accounting practitioner), could become one of the effective internal corporate governance mechanisms (CGM) to bring down the earnings management activities. This study attempts to provide insight into the level of conservatism of the CEO with an accounting background. Following Basu (1997) and Khan and Watt (2009), the firm-year measure of conservatism (C_Score) was obtained, which later was associated with the accounting education of the CEO to determine their relationship. As expected, CEOs with accounting background exhibit a higher level of moral reasoning than their non – accounting educated counterparts. The finding of this study is useful to persuade the policymaker to consider lifting the trend of hiring a CEO with an accounting background as one of the best practices that the companies can work out to lessen earnings management activities.

Keywords: Earnings Management, CEO, Accounting Background, Accounting Conservatism

JEL Classification Code: G3, G34, G38

1. Introduction

Generally, the educational background has become a common basis to understand an individual's expertise and skills related to a particular field or domain. Kaplan and Rauh (2013) examined Forbes 400 richest Americans and found that those in the Forbes 400 are less likely to have inherited their wealth or to have grown up wealthy. They concluded that access to education has become more important in wealth generation, among others, because education provides valuable skills. Selecting a new CEO is among the most delicate decisions a board of directors will ever face. The selection process is exposed to so many unknowns: personality, integrity, technical skills, education, and experience. Being educated is a vital attribute to any CEO as the success of the firm depends on their ability and skills to maneuver the firm. In the accounting world, the rise of corporate accounting scandals and the introduction of the Sarbanes Oxley Act 2002 has increased the need for hiring accounting graduates to hold important posts in the organization. According to Fino (2018), 18% of CEOs in the UK's FTSE (The Financial Times Stock Exchange) 100 companies have an accountancy qualification, and 51% of the CEOs have a background in finance. These statistics have shown a big preference shift in hiring CEOs with an accounting and finance background. In the past, the majority of the CEOs had a sales or marketing background.

A preliminary study through a manual search documented the same pattern in Malaysia, where 12 out of 30 companies in Malaysia's FTSE Top 30 companies in the year 2017 have CEOs with an accountancy qualification. However, this increasing trend of hiring CEOs with accounting backgrounds still lacks empirical support (Hu et al., 2017). Perhaps, CEOs

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with an accounting background are hired because of the belief that people with an accounting background are deemed capable to provide high-quality financial reporting because theoretically, they have acquired all the necessary skills and knowledge during their tertiary education in upholding what constitutes the proper way of reporting the financial information of a company. This includes adherence to the ethical values to further ensure that the financial information reported represents the true view of the company's financial condition. By having more truthful reporting practices, the corporate community, in a way, shows to the public that they are building effective and accountable institutions where people can make productive investments, thus contributing to economic growth. The quality reporting practices are also meant to protect investors' rights as they rely on financial information before making their investment decisions. A good decision can only be made if the investors have the financial information which reflects the true economic condition of a company. If the policymaker can consider enforcing more corporate governance mechanisms (CGMs) as suggested by the findings from this study, then promoting peace, justice, and strong institutions among the corporate community can be a fruitful move.

2. Literature Review

Wally and Baum (1994) argued that a CEO's formal education is a proxy of a CEO's cognitive ability, which helps CEOs acquire and process more complex information and make decisions faster. They found that CEOs' cognitive ability, use of intuition, tolerance for risk, and propensity to act are associated positively with speedy decisions. Formal education also may indicate a CEO's instinct towards his or her interest and openness to new concepts. Thus, individuals with formal education often are more receptive to new ideas. Similarly, formal education provides opportunities for CEOs to accumulate rich knowledge bases and skillsets. In turn, formal education might equip CEOs with the capacity to be more flexible in understanding and process information about changing business environments, new technologies, and any relevant change as required by the regulations that have impacts on the current business operations. In support of these arguments, Kimberly and Evanisko (1981) found that formal education was positively related to individuals' receptivity to innovation and change; thus, by the extension to the findings, a CEO's formal education may increase the CEO's desire to pursue more novel, complex, and significant firm strategies. In a recent study conducted by Ghardallou et al. (2020), they found out that the stock performance in 120 Saudi's listed firms on the Tadawul stock exchange from 2014 to 2017 increased in line with the level of education of the CEOs in the respective firms. Their findings proved that the CEO's educational background does matter. In particular, companies employing CEOs with business administration, economics, finance, or accounting degree will perform outstandingly better. Similarly, stock performance gets improved when the CEO has a postgraduate qualification, i.e. when the CEO holds an MBA, a master's, or a Ph.D. degree. Overall, these findings demonstrate that executives' attributes are key factors that would explain differences in Saudi firms' performance.

In another study by Basmah and Lakshmi (2020), the authors found that graduate CEOs are found to enhance performance. This finding suggests that investors do consider the CEO's education when deciding whether to invest in the capital of the company or not. This implies that investors are more confident to invest in companies led by educated CEOs. The success of a firm depends on the CEO's ability. Hence their study suggested that firms can benefit from a CEO hiring policy that emphasizes the minimum qualification set as graduation or higher. Wang et al. (2016) used meta-analytic techniques to synthesize prior Upper Echelons Theory (UET), research on the relationships among commonly studied CEO characteristics, firm strategic actions, and future firm performance. The results showed that CEO characteristics (i.e., tenure, formal education, prior career experience, and positive self-concept) are significantly associated with firm strategic actions, which in turn are significantly related to future firm performance. Moreover, CEO characteristics (i.e., age, tenure, formal education, and prior career experience) are positively related to future firm performance. They found that CEO formal education is one of the CEO characteristics that influence the CEO to perform specific firm strategic actions. In this study, the CEO's accounting background refers to the CEO's formal accounting education from formal schooling the CEO had in his or her tertiary level of education.

According to Rest (1999), an ethical reasoner is not bound by rules and conventions but interprets all ethical decisions through the lens of fundamental ethical norms. This means that a person will judge moral issues based on greater principles and what constitutes the ideal resolution given the current situation rather than self-interest or adherence to laws and rules. This is relatable since accounting and the financial reporting environment evolves over time, and the presence of accounting conservatism needs to be in place. Following the financial reporting rules, managers with accounting backgrounds should exercise caution related to: first, while accounting rules provide some discretion to accountants, following rules suggest less incentive for earnings management. Second, the accounting standards possess ambiguous provisions (Harding & Xu, 2011), and that a good accountant will interpret them neutrally. Hence, a CEO with an accounting background who possesses a higher level of accounting conservatism is preferred by companies when it comes to hiring a CEO for the company.

Accounting conservatism refers to financial reporting guidelines that require accountants to exercise a high degree of verification and utilize solutions that show the least aggressive numbers when faced with uncertainty. It is a longstanding principle in financial reporting intended to protect users of financial information from inflated revenues and to make sure that all potential liabilities are recorded as soon as they are realized. The idea of emphasizing the need for accounting conservatism is to ensure the quality of financial reporting, thus, providing a meaningful guideline for investors and analysts to use the financial information (Matsunaga & Yeung, 2008). Therefore, understanding the managerial behaviors is vital to form a control mechanism of some sort to enhance earnings quality, which in turn would increase the company's performance (Saleh et al., 2020). This study emphasizes the role of formal education as one of the key attributes of a CEO because CEOs are often involved directly with deciding the financial and investment policies for the company (Cullinan & Roush, 2011). Hence, a CEO has a significant role in safeguarding the company to serve the interest of shareholders as described in the Agency Theory. Agency theory is a principle that is used to explain and resolve issues in the relationship between business principals and their agents. Most commonly, that relationship is the one between shareholders, as principals, and company executives, as agents. Thus, the following hypothesis is formulated:

***H1:** There is a significant relationship between a CEO with an accounting background and accounting conservatism.*

This study also incorporated variables such as the CEO's demographic attributes as well as other corporate governance mechanisms, namely the composition of independent directors on board, the composition of women directors on board, the size of audit firm auditing the company, and the largest shareholders.

3. Data and Methodology

This study uses the data from the Malaysian public companies which were listed on the FTSE Malaysia top 100 companies in the year 2018. The period selected for this study was from 2013 until 2018. Following the prior studies, all financial institutions and real estate investment trusts are excluded from the sample for they possess different kinds of accounting data and are subject to a different kind of regulation. Besides, companies with insufficient data for the years under study are also excluded from the sample. After the filtration of data, the final sample consists of only 69 out of the 100 companies listed on Malaysian FTSE Top 100 companies, with a total of 414 observations.

There are few corporate governance variables involved in this study. First, the accounting background of the CEO will be taken from the companies' annual reports - coded 1 if the CEO has an accounting background (i.e., a bachelor degree in accounting, member of any professional accounting bodies or an experienced CFO before his or her tenure as CEO); coded 0 if the CEO does not have an accounting background. Second, CEO demographics are represented by CEO's gender and age. CEO's gender is a dummy variable where the company will be coded 1 for male and coded 0 for female. CEO's age will be the age of the CEO during the year where the data is taken. Last, this study also incorporates other corporate governance mechanisms normally used by prior studies related to corporate governance in Malaysian firms, which are the independent board of directors, big four audit firms, largest shareholding, and women on board. The independent board of directors is measured according to the number of independent directors on the board. The size of the audit firm is a dummy variable where the company is coded 1 if the company employed one of the big four audit firms and is coded 0 otherwise. Next, the largest shareholding refers to the percentage of the top1 shareholding as published in the company's annual report. Finally, the composition of women on board is measured according to the number of women directors on board divided by total board members.

This study adopted the firm-year measure of conservatism from Basu (1997), and the cross-sectional regression is specified as follows:

$$X_i = \beta_1 + \beta_2 \mathrm{D}_i + \beta_3 \mathrm{R}_i + \mathrm{ß}_4 \mathrm{D}_i \mathrm{R}_i + e_i \tag{1}$$

Where;
$_i$ = firm index
X = earnings
R = annual returns compounded from monthly returns beginning the fourth month after fiscal year end (measuring news)
D = dummy variable; equal to 1 when R < 0 and equal to 0 otherwise
e = residual

Following Khan and Watts (2009), $ß_3$ (G_Score) is the good news timeliness measure while $ß_4$ (C_Score) is the measure of incremental timeliness for bad news over good news or conservatism. Both scores are calculated using the linear functions of firm-specific characteristics for each year as follows:

$$\mathrm{G\_Score} = \beta_3 = \mu_1 + \mu_1 \mathrm{Size}_i + \mu_1 \mathrm{MTBV_i} + \mu_1 \mathrm{Lev}_i \tag{2}$$

$$\mathrm{C\_Score} = \beta_4 = \lambda_1 + \lambda_2 \mathrm{Size}_i + \lambda_3 \mathrm{MTBV}_i + \lambda_4 \mathrm{Lev}_i \tag{3}$$

Where;
Size = firm's total revenue

MTBV = firm's market – to – book value
Lev = firm's leverage

Empirical estimators of μ_1 and λ_1, $i = 1 - 4$, are constant across firms but vary over time since they are estimated from annual cross-sectional regressions. Equations (2) and (3) are not regression models. Instead, they will be substituted into equation (4) to obtain equation (1), which is the annual cross-sectional regression model used to estimate C_Score and G_Score, as shown below:

$$X_i = \beta_1 + \beta_2 D_i + R_i(\mu_1 + \mu_2 \text{Size}_i + \mu_3 \text{MTBV}_i + \mu_4 \text{Lev}_i) + \text{Di}\,R_i(\lambda_1 + \lambda_2 \text{Size}_i + \lambda_3 \text{MTBV}_i + \lambda_4 \text{Lev}_i) + (\delta_1 \text{Size}_i + \delta_2 \text{MTBV}_i + \delta_3 \text{Lev}_i + \delta_4 D_i\,\text{Size}_i + \delta_5 D_i\,\text{MTBV}_i + \delta_6 D_i\,\text{Lev}_i) + e_i \quad (4)$$

C_Score and G_Score vary across firms through cross-sectional variation in the firm-year characteristics (size, market to book value, and leverage), and over time through intertemporal variation in λi,t, μi,t and the firm-year characteristics. Conservatism is increasing in the C_Score. Following Hu et al. (2017), the C_Score is associated with accounting education, CEO demographic, and other corporate governance mechanisms as follows:

$$\text{C\_Score} = \beta_0 + \beta_1 \text{CEO\_edu}_{it} + \beta_2 \text{CEO\_g}_{it} + \beta_3 \text{CEOage}_{it} + \beta_4 \text{Com\_ID} + \beta_5 \text{Com\_WOB}_{it} + \beta_6 \text{Big4}_{it} + \beta_7 \text{Top1}_{it} + \varepsilon_{it} \quad (5)$$

A regression model of the accounting conservatism on the CEO's accounting background as moderated by the CEO's compensation is adopted as follows:

$$\text{C\_Score} = \beta_0 + \beta_1 \text{CEO\_edu}_{it} + \beta_2 \text{CEO\_g}_{it} + \beta_3 \text{CEOage}_{it} + \beta_4 \text{Com\_ID}_{it} + \beta_5 \text{Com\_WOB}_{it} + \beta_6 \text{Big4}_{it} + \beta_7 \text{Top1}_{it} + \beta_8 \text{Comp}_{it} + \beta_9 \text{Edu\_Comp}_{it} + \varepsilon_{it} \quad (6)$$

4. Findings and Discussions

The characteristic of the data used in examining the relationship between the CEO's accounting background and accounting conservatism is presented in Table 4.1. Other variables that are used to achieve the objective were not included in the descriptive statistic below, for they are dichotomous variables that are coded 1 and 0. Dichotomous variables used to achieve this objective are CEO's accounting background (CEO_edu), the CEO's gender (CEO_g), and the big four audit firms (Big4). The remaining variables were explained as follows:

Based on the descriptive statistic table above, on average, the firms included in the sample have a C_score of -204.3789. As for age, the CEOs are aged between 30 to 74 years old. On average, the firms included in the sample have their board populated by independent directors (Com_ ID), which make up 47.4669% of the board composition. As for the composition of the woman director on board (Com_WOB), some companies still have not appointed a woman as a board member, as depicted by the minimum value of 0. However, overall sample firms have appointed at least 1 woman director. As for the percentage of the largest shareholding is concerned (Top1), most of the sample firms have highly concentrated ownership, with 33.7532% of the firm's shares held by a single shareholder.

The correlation analysis highlights the strength and direction of the relationship between the variables. Based on the correlation table below, all of the variables' correlations are close to 0. This indicates that no linear relationship between the variables.

The regression result for the relationship between the CEO's accounting background and the level of accounting conservatism was depicted in Table 4.3. The result was interpreted based on Newey West's robust test after an earlier test on the poolability (BPLM test, p-value 0.1102) failed to reject the null. Hence, it cannot proceed to fixed and random effects testing.

Table 1: Descriptive statistic

Variable	Min	Mean	Max	Std. Dev.	Skewness	Kurtosis
C_score	-26543.93	-204.3789	2128.194	1625.557	-13.82752	207.556
CEOage	30	54.0435	74	7.7789	-0.1564	2.9539
Com_ID	7.69	47.4669	80	12.0209	0.1305	2.5238
Comp_WOB	0	16.5741	57.1429	11.3054	0.3641	2.8858
Top1	4.34	33.7532	73.4	19.0017	0.2983	1.9920
N	414					
n	69					
t	6					

Table 2: Correlation

Variable	C_score	CEO_edu	CEO_g	CEOage	Com_ID	Comp_WOB	Big4	Top1
C_score	1.0000							
CEO_edu	0.0723	1.0000						
CEO_g	-0.0620	-0.1829	1.0000					
CEOage	0.0142	-0.2177	0.0434	1.0000				
Com_ID	0.0180	-0.0010	0.0327	0.0742	1.0000			
Comp_WOB	0.0132	0.1031	-0.0578	-0.0890	-0.0178	1.0000		
Big 4	-0.0058	0.1289	-0.0794	-0.0405	0.1837	0.0125	1.0000	
Top1	-0.0420	0.0745	-0.0217	-.0507	0.1171	0.1940	0.1534	1.0000

As shown in Table 3, a CEO with an accounting background shows a higher level of accounting conservatism as compared to his/her non-accounting educated counterparts. This can be seen from the statistic that shows a 10% significant level (p-value 0.064), CEO_edu has a positive relationship with accounting conservatism. This indicates if the CEO has an accounting background, he/she will be 318.7615 more accounting conservative. Thus, the null hypothesis has been rejected. This finding confirms the old UET by Hambrick and Mason (1984) as cited by Wang et al. (2016), who suggested the CEO's formal education could influence the CEO's behavior to perform certain firm strategic actions. This result implies that CEOs with accounting backgrounds are more conservative than their non-accounting background counterparts. Since the preference to hire CEO with accounting background sparked an upwards trend after the pre-Sarbanes – Oxley (SOX) Act was introduced in 2002, this finding is rather a piece of evidence that companies who do not want to suffer the same faith as Enron should hire a CEO with accounting background to help enhance the quality of financial reporting. The need to have a CEO with an accounting qualification can also be highlighted given the fact that accounting standards possess ambiguous provisions (Harding & Xu, 2011). Thus, a good leader with an accounting background (who is supposed to be more conservative) will interpret the standards neutrally. Therefore, the quality of reporting should increase tremendously.

There are two CEO's demographic attributes being examined, namely CEO's gender and CEO's age. Interestingly, the CEO's gender was found to have a negative relationship with accounting conservatism. This finding suggested that male CEOs have a soft side for earnings management, thus possess a lower level of accounting conservatism as compared to their female counterparts. This can be seen from the regression result above, where at a 1% significant level (p-value 0.001), CEO_g has a negative relationship with accounting conservatism. This result serves as evidence that female CEOs are more cautious, less aggressive, more risk-averse, and subsequently become more conservative in their way of executing their responsibility towards the firm. Hence, investors should be more careful when making investment decisions in firms that are headed by male CEOs. Other corporate governance variables, namely, CEO's age (CEO age), the composition of an independent director on board (Com_ID), and the composition of women on board (Comp_WOB) have a positive but insignificant relationship with the level of accounting conservatism. These results indicate that the CEO's age, the number of independent directors, and women directors on board do not influence the level of accounting conservatism possessed by the firm. Other variables, namely, the big four audit firms (Big4) and the largest shareholdings (Top1) have a negative but insignificant relationship with accounting conservatism. Likewise, these results depict that the big four audit firms and the largest shareholdings do not influence the level of accounting conservatism possessed by a particular firm.

5. Conclusion and Recommendation

While many prior studies had been conducted in search of effective corporate governance mechanisms, all is to combat the financial manipulations (i.e. earnings management) done by the corporate players that never seem to vanish from the business world. This gives a continuous threat to the safety of the shareholders' investment. Therefore, this study attempts to extend the accounting literature on the specific corporate governance mechanism by looking at the possible contribution from CEOs with an accounting background in improving corporate practices. This study found that CEOs with an accounting background appear to be more conservative as compared to their non-accounting educated counterparts. From the Agency Theory perspective, monitoring implies overseeing the actions of the agent in making sure that the interests of the shareholders are being safeguarded. This is where the finding of this study is valuable because it gives insight to the shareholders on the ideal characteristic of the person who should hold a post as CEO in the company that they invest in. Furthermore, this study also found that male CEOs are more prone to engage in earnings management as compared to their female counterparts. This finding should serve as the guideline for any future investors who wish to broaden their investment portfolios, especially in the process of selecting or evaluating which company they should invest in. They should be more careful in evaluating companies that are headed by male CEOs.

Table 3: Regression Results

Variable	Newey - West
CEO_edu	
Coefficient	318.7615
t-value	1.86
p-value	(0.064)*
CEO_g	
Coefficient	-552.087
t-value	-3.38
p-value	(0.001)***
CEOage	
Coefficient	5.9793
t-value	0.63
p-value	(0.528)
Com_ID	
Coefficient	3.6192
t-value	0.84
p-value	(0.401)
Comp_WOB	
Coefficient	2.2661
t-value	0.56
p-value	(0.577)
Big4	
Coefficient	-62.5361
t-value	-0.52
p-value	(0.601)
Top1	
Coefficient	-4.3590
t-value	-1.32
p-value	(0.189)
Constant	
Coefficient	-54.2689
t-value	-0.11
p-value	(0.912)
R_squared	N/A
F-Stat	0.0000
BPLM Test	
Chi2	1.50
P-value	(0.1102)
N	414

Notes: * denotes significance at the 10% level, ** denotes significance at the 5% level, and *** denotes significance at the 1% level. N/A: not applicable.

Future research could be further extended to look at the comparison across the industries that can be utilized to examine whether there is a difference in the level of accounting conservatism of the CEOs based on the industry they are in. The CEOs' educational background could also be considered as a moderating variable in the relationship between accounting conservatism and earnings management in the respective industries.

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