

# Firms Audit Committee and External Auditor Influence on Accounting Conservatism and Firm's Performance

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## Abstract

In this study we have examined the effect of internal audit committee and external auditor quality on accrual-based measures of accounting conservatism, and the benefits of accounting conservatism on firms' market performance. Moreover, this study also investigates whether the accrual-based conservatism mediate the relationship between audit committee and external auditor quality factors with market-based firms' performance. A total of 543 sample firms are selected from the Bursa Malaysia for the period from 2004 to 2013. For data analysis, panel data methodology is employed and structural equation modeling (SEM) technique is used to test the developed hypotheses of this study. Results show that audit committee effectiveness and external auditor quality found to be significant with two-year-lagged effect on accrual-based measure of conservatism. Furthermore, accrual-based measure of conservatism mediated the relationship between (a) audit committee effectiveness and market-based firms' performance, and (b) external auditor quality and market-based firms' performance. The findings of this study contribute to the signaling theory, agency theory, reputation theory and accounting conservatism literature in emerging economies settings.

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**Keywords:** Accounting conservatism, signaling theory, firms' performance, Malaysian listed firms, lagged effects.

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## Introduction

Accounting conservatism is well-thought-out as a fundamental characteristic of financial reporting in relation to earnings quality since it enhances the reliability of financial statements and minimizes the information asymmetry (Mohammad, Ahmed and Ji, 2010; Jeffrey et al., 2014) and monitor and control over overinvestment particularly in research and development cost (Lara et al., 2016). The conventional definition of accounting conservatism (Bliss, 1924 as cited by Watts, 2003; Ren, 2014) that states "anticipate no profit but anticipate all losses" which is also called unconditional conservatism. This concept is later termed as an asymmetric timeliness of earnings which requires early and timely recognizing of bad news as an expected loss and deferring the good news as expected gain (Basu, 1997). This concept presented by Basu (1997) is one of the popular tools for measuring the conditional conservatism. Hence, both explanations (unconditional and conditional conservatism) have defined the accounting conservatism as understatement of earnings rather than overstatement. Later, Ball and Shivakumar (2005) developed accrual models to determine a firm's degree of conditional conservatism. They demonstrated that operating accruals capture economic losses in a timelier manner than gains, and these accruals serve as an asymmetric function of firm performance.

The principle of conservatism helps in reducing conflicts regarding debt-contracting and managerial contracting and is advantageous for the business in many ways. Firstly, as discussed by Watts (2003), it limits the management's overpayment by timely recognizing losses and by delaying or deferring gain recognition. Secondly, it also restricts the management to invest in risky projects that can have negative NPV (net present value) as also referred to the "prudent concept" (Lara, Osama, and Penalva, 2009). Thirdly, management is also more inclined towards abandonment of the projects with negative NPV by following the conservative accounting principle (Watts, 2003). Fourthly, these principles (of conservatism) also forced the accountants to report true efficiency of their firms in terms of earning quality and net worth. In the light of all these advantages of accounting conservatism, a positive association of the strength of accounting conservatism and performance of the firm is emerged (Duellman, 2006; Lara et al., 2016).

## Motivation of Study

In Malaysia two types of conflicts are commonly encountered by family ownership, i.e. debt-contracting and managerial-contracting between principal to agent and agent to creditor; though they are more common than the traditional principal to agency conflict (Wei, 2007; Kung et al., 2008). The current study is interested to evaluate the effect of signaling theory (Wong et al., 2009; Jeffrey et al., 2014) and worth of conservatism in

minimizing the debt and managerial contracting conflicts. Moreover, the current research study is also interested to examine how conservatism replies to signal (i.e. the positive/negative news from market) and how to deliver the information to market. Additionally, the debt and managerial contracting conflicts are very crucial because of the weak legal protection of minority stockholders in Malaysia (Fei, 2014); therefore, it becomes very essential to investigate the worthiness of conservative accounting and factors of conservatism in the listed firms of Malaysia.

It is significant to note that majority of the research in this context is conducted with respect to developed markets such as US and UK. For example, a sample from UK firms was examined and a direct relationship is found between audit committee and conservatism by Beekes et al. (2004). Similarly, US companies are explored by Ahmed and Duellman (2007) who reported that conservatism is beneficial to managers in minimizing the agency costs of the firms in US. Research also found that firms with a higher proportion of independent audit committee experienced better performance (Daily and Dalton, 1992; Ren, 2014). In fact, as argued by Mohammed et al. (2010), strong audit committee was exhibited to implement accounting conservatism as governance tool to manage firm's performance. However, these outcomes have not been applied over the emerging markets (such as Malaysia) since the structure of corporate governance is quite different from that of developed markets.

Although, the audit committee toward firms' performance could not get the due attention by the researchers, still there are some other important factors (such as external auditor quality) that might have some impact on the degree to which conservative accounting practices are observed to. For instance, according to few studies (e.g. Klein, 2002a; Mangena & Pike, 2005; Ling, 2007; Krishnan & Visvanathan, 2008), it is supposed that the level of effectiveness of an audit committee is directly related to greater earnings conservatism as compared to some other factors (such as firm's market competition, firm's leverage, managerial influence, firm's size, predictability of future profit and firm's operating risk). But, as was the case of audit committee, there is no specific measure of audit committee effectiveness. Some of the corporate governance advocators suggest that the audit committee's effectiveness is basically the function of some important factors e.g. independence, financial expertise, and diligence (e.g. DeZoort et al., 2002; Abbott et al., 2003a; Abbott et al., 2004; Noland, Nichols and Flesher, 2004), yet they encompass some other variable e.g. external auditor quality. Hence, it becomes another motivating factor for this study to investigate the audit committee effectiveness along with other variable (external auditor quality) in the context of Malaysian markets.

The role of external auditor quality and internal audit committee is very crucial particularly in case of internal governance because they are responsible for the strategic guidance and effective monitoring of manager and together with stockholders (Cahna and Zhang, 2006; Tsui, 2010; and Masdiah, 2013). Similarly, the conservative accounting is useful to the manager in fulfilling their role in monitoring crucial decisions (Ho, 2009). The influential and powerful audit committees lead to higher degree of conservatism and therefore minimize the debt and managerial contracting conflicts.

On the other side of current study, there is another motivation that we found is “lagged effect” of audit committee and external auditor quality on degree of accounting conservatism. There are some explanations for lagged effect on accrual-based conservatism and asymmetrical timeliness conservatism as it was originated from capital market returns. First, Jones and Kua (1996) and later Khan (2014) claimed that significant coefficients of lagged effect of oil prices on stock returns declare that either stock markets are inefficient, or the endogenous factor (audit committee) and exogenous factor (external auditor quality) of firm bring variations in expected stock returns. Therefore, the spotlight of this phenomenon spells that lagged effect of endogenous and exogenous factors might occur either due to managers’ inefficiency or they receive late information.

Secondly, Hong et al. (2007) have introduced diffusion hypothesis, a different but potential channel through which underreaction of managers can occur. They (Hong et al., 2007) described a model which comprises of ‘momentum traders’ and ‘news watchers’. They documented that a news watcher cannot extract the information from the prices of other news watcher since he observes some private information. This leads to the gradual information diffusion hypothesis. Hong et al. (2007) extended this model by introducing “limited information processing capacity hypothesis”. It explains that most of the managers do not pay full attention (or may ignore) to the publicly available information. Hence, managers respond differently to the information at different point of time, leading to delayed reaction to the publicly available information.

Therefore, all the above-mentioned arguments and justifications from the financial literature decree the significance of lagged effect of endogenous and exogenous factors on managers/investors. Therefore, this study for the first time particularly in emerging markets of Malaysia, empirically explores the lagged effect of endogenous and exogenous factors on managers conservative policy in their respective firms. Finally, based upon recommendation of Khan et al. (2014c) who have suggested future study on lagged effect on capital market, this study has also explored lagged effect of endogenous and exogenous factors on managers conservative policy for their firms in Malaysian market.

Keeping in mind the unique transitional features of Malaysian corporate governance, the current paper covers the investigation of audit committee effectiveness and external auditor quality and accounting conservatism in listed companies of Malaysia with corporate reforms and the application of accounting standards relating to accounting conservatism.

## **Literature Review and Hypotheses Development**

### *Audit Committee Effectiveness and Conservatism*

There are few empirical researches that give the relation between conservatism and internal audit committee. However, the previous study on the subject indicates the link between audit committees and the quality of earnings. This suggests that there is a relationship between audit committee and conservatism (DeFond, Hann and Hu 2005; Klein 2002a, DeZoort et al., 2002). The presence of the audit committee does not give an

assurance of the automatic link between the audit committee and conservatism, it should be noted that an effective audit committee is one that determines that the other sub-committees will be committed to develop a specific degree of conservatism (Turley and Zaman, 2007; Dhaliwas, Naiker and Navissi, 2006; Vafeas, 2005). The definition of the effectiveness of an audit committee is found in DeZoort et al. (2002 p. 41) where they quote for other scholars, the definition below was developed by Cohen et al (2004) and Vera-Monz (2005) which was applicable to this research:

“An effective audit committee has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts.”

Other comprehensive research suggests that the most effective audit committees improve the quality of earnings (Turley and Zaman 2007; Steward and Munro 2007; Lennox and Park 2007; Karamanou and Vafeas 2005). The most effective audit committees eliminate the behavior of the corporate management to engage in opportunism that will affect the quality of the earnings (Klein, 2002b). An effective audit committee also has a greater ability to turn down an aggressive financial accounting policy chosen by the corporate management that reduces conservatism of the earnings. Finally, an effective audit committee is active in arbitration in systematic compromises between the external parties and the management of the firms, for example, the external auditors and the management of the firm (DeZoort and Salterio, 2001).

Conservatism reports a higher quality accounting system; therefore, the audit committees will adopt this mode of accounting in the organizations they are engaged in and ensure management is able to abide.

Hence:

*H<sub>1</sub>: Ceteris paribus, an internal audit committee's influence positively to the degree of accrual-based accounting conservatism.*

### *External Auditor Quality and Conservatism*

Chung et al. (2003) argued that auditors want their clients to make the choice of conservative accounting rather than liberal to lessen the risk of litigation as well as to protect his reputational capital. The authors anticipated and demonstrated that big auditing firms are more effective than smaller firms in limiting income-increasing accrual because big audit firms are more likely to be exposed to the risk of litigation in the situation of a failure of audit which leads to loss of reputational capital. By using conservatism, Cahan and Zhang (2006) and Krishnan (2007) provided support to auditors of ex-Andersen clients to lessen their risk of litigation. Cahan and Zhang (2006) found discretionary or lower abnormal accruals in clients of ex-Andersen as compared to a corresponding sample. To support the clients of big auditors with greater extents of conservatism, Krishnan (2007) applied the Basu (1997) measure of AT. The clients of ex-Andersen were prospected as a unique form of litigation risk and their own reputational capital. Francis et al. (1999) found that firms have more tendencies to hire big auditor

firms if they have higher levels of accruals for providing an indication that these accruals are plausible and catch the attention of more internal and foreign investors. Francis et al. also found that after managing for numerous firm-specific features the intensity of discretionary accruals is considerably less for Big Six clients than for others. Auditors are among the major groups likely to be exposed to risk of litigation, but this risk can be forwarded to firms by auditors who are not as eager to accept aggressive accounting (Kinney & Uecker, 1982; Pae et al., 2003; Qiang, 2007). In fact, for conservatism, Qiang (2007) used big audit firms as a proxy because of the risk of litigation and risk of losing reputation in market. Based on past research, big audit firms or auditors from firms that are well-reputed manage the level of conservatism more accurately.

Past researchers (e.g. Balsametal., 2003; Francis, 2004; Caramanis and Lennox, 2008) have reported that higher auditor quality is more likely to seek to enforce and encourage conservative earnings practices in the firms. Furthermore, a higher quality auditor has strong motivations to auditors as a means of ensuring clients report higher quality earnings among public. In fact, higher quality auditor protects the interest of stakeholders, and as a consequence, enhance reputational capital and reduce litigation risk of a firm (e.g. Francis, 2004; Caramanis and Lennox, 2008).

It is reported (Rapani, 2011) that high brand name audit firm have incentives to reduce political costs arising from any litigation action if financial statements of a client are found to be overstated or incorrect. Therefore, highly recognized audit firm with high amount of reputational capital is more likely to be vigilant on examining clients' accounts and is expected to be more aggressive in safeguarding the rights of stakeholders while adopting conservative accounting practices toward quality of reported (Rapani, 2011).

Thus:

*H<sub>2</sub>: Ceteris paribus, external auditor influence positively the degree of accrual-based accounting conservatism.*

### *Conservatism and Firm's Performance*

Conservatism is aimed at increasing the performance of a firm through limiting opportunism of the managers. According to Roychowdhury and LaFond (2008), the managers who have their tenure and liability limited have a higher probability of overstating the earnings and stating unverifiable future cash flows for interests best known to themselves. Such overstatements result to the managers being paid more than the required by the company policies by hinder the actual performance of the firms. Conservatism becomes key in constraining the ability of the managers in manipulating the total equity and the net assets (Watts and Zuo, 2011). Sometimes the managers are often tempted to undertake projects with negative NPVs in the long run with the aim of maintaining the current earnings at the present. Conservatism will be quick in pointing out these economic losses expected from projects that have a negative net return, which reduces the ability of the managers from engaging in activities that have a negative net outcome (Watts and Zuo, 2011). In another study, Razzaq et al (2016) stated that

accounting conservatism improved the efficiency in the investment of the Chinese firms, using the data collected from listed companies from 2002 to 2013.

Most of the firms in Malaysia are family owned business entities and they will monitor the management closely to prevent any misappropriations (Fei, 2014). The major sources of conflicts in these firms are the agency conflicts between the controlling and the non-controlling interest stakeholders are prevalent rather than conflict between the shareholders and the managers. The controlling interest has the tendency of exploiting the non-controlling interest shareholders; they sometimes transfer resources from the firms to themselves through related party transactions (Wu, 2011). Conservatism is good in ensuring that the controlling interest does not exploit the other shareholders through mitigation of information asymmetry. Conservatism is therefore important for the firms in Malaysia through lessening of the asymmetry of information.

Based on above arguments, the following hypotheses are proposed: Based on above arguments, the following hypotheses are proposed:

*H<sub>3</sub>: Ceteris paribus, a firm that employs more accrual-based accounting conservatism has better firm's performance than a firm that employs less conservatism.*

#### *Accounting Conservatism as a Mediator*

Although no one has investigated accounting conservatism as a mediator of the endogenous and exogenous variables with firm's performance link, researchers have demonstrated relationships between audit committee and external auditor variables with accounting conservatism (Garcia Lara et al., 2009; Ahmed and Duellman, 2007; Krishnan & Visvanathan, 2007) and between accounting conservatism and firm's performance (Razzaq et al., 2016; Watts, 2003a; Pae et al., 2005; Watts & Zuo, 2011; Dhole, 2010; Lara et al., 2009a; 2009b; LaFond and Roychowdhury, 2008). However, despite literature suggesting that (a) audit committee and external auditor variables are related to accounting conservatism, (b) accounting conservatism is related to firm's performance, and (c) audit committee and external auditor variables and task performance may be linked through some mediating mechanism, the intervening influence of accounting conservatism on the relationship between endogenous-exogenous variables and firm's performance has yet to be investigated. This mechanism of mediating role is supported by Whitaker et al. (2007) in feedback scale development in their study. To this end, this study hypothesizes the following:

*Ceteris paribus, (H4a) audit committee effectiveness and (H4b) external auditor quality will affect firm's performance.*

*Ceteris paribus, accrual-based accounting conservatism will mediate the relation between (H5a) audit committee effectiveness and firm's performance, and (H5b) external auditor quality and firm's performance.*

### Conceptual Framework of Study

The conceptual framework of this study is based on two models developed by previous scholars like Wang et al (2009) and Gigler et al. (2009). The theory of Gigler et al. is established on the moral hazard model; on the other hand, the idea of Wang et al. is developed on the signaling model. According to Gigler et al. (2009), the degree of accounting conservatism is affected by an endogenous variable while Basu (1997) portray its effect as an exogenous variable. In this study, one endogenous variable, such as the audit committee effectiveness, and one exogenous variable being considered, such as external auditor quality. These variables are used in resolving issues in the accounting literature. The proposition of the signaling theory is that conservatism absorbs all the internal and external signals and recognizes it in the financial reports, so that the earnings are controlled and managed with the aim of reducing managerial contracting, debt-contracting, and litigation conflicts. Conservative accounting is therefore thought to increase the value of the firm and various beneficial advantages to the stakeholders of the different firms. The special advantages of conservatism have made firms come from strong audit committees and quality external auditors to adopt this accounting method. The reason behind the use of ACCRCON is that conservative accounting gives persistent negative accruals (Duellman, 2006). The higher the negative accruals in the period of measure the higher the degree of conservatism. Ball and Shivakumar (2005) developed accrual models and have claimed that their contribution plays an important role in developing conservative accounting policy for both discretionary and nondiscretionary components of accounting accruals. The proposition here studies the effect of endogenous-exogenous variables that influence conservatism and the performance of different firms in the context of Malaysia’s economy. The impact of conservatism on performance is also assessed. The expected outcomes from conservative accounting policy to better performance is due to timely recognition of the negative economic signals.

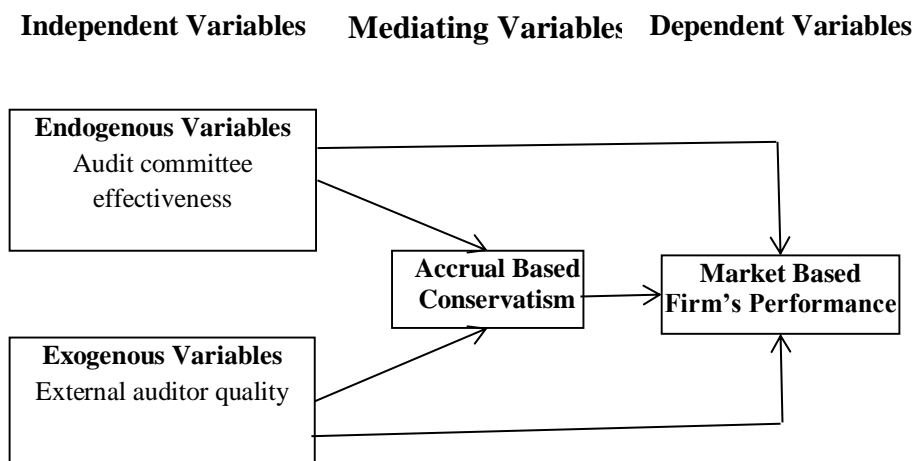


Figure 1: Conceptual Framework



## Methodology

### *Sample Selection*

The population samples selected was comprised of all the publicly listed companies on the Bursa Malaysia from 1st January 2004 to 2013. The firms of Bursa Malaysia were chosen because their information is publicly available. The information provided by the firms is also in a readily usable form and does not need any manipulation for it to be effectively used. When the sample selection was made, the firms that were operating in the insurance and utilities, finance and banking industry, excluded because they have different regulatory boards that determine their operations (Givoly, Hayn and Natarajan, 2007; Ruddock et al, 2006). The other excluded firms were those that were not present continuous through the entire period of the study for example IPO firms and those firms that were delisted before they were re-listed again. The next category of firms not included in the research was those that were involved in mergers and acquisitions since such activities have an impact on the extent of the financial reports taken (Salter, 1998). According to Evans and Clifford (1997), unit trusts and foreign firms domiciled outside of Malaysia do not qualify for consideration in this study because their financial statements are not prepared in accordance with the requirements of disclosure of the firms listed on Bursa Malaysia. The next group excluded is of those firms where there is a suspicion that its financial data is missing for more than three years in the period of study (Klein, 2002b).

Finally, 543 firms were selected from the pool depending on the availability of its data (see Table 1). The collected information is from the yearly financial information available from the firms. The resulting sample is 3660 firm-year observations of the data sets, the subsequent tests are done on the firms as outlined in the table below:

Table 1: Final Sample by Industry

No.	Industry	<sup>1</sup> Population	<sup>2</sup> Sample	Per. within sample (C4÷C3)
1	Trading & Services Firms	206	140	67.96
2	Property Development Firms	87	48	55.17
3	Technology Firms	97	45	46.39
4	Consumer Products Firms	135	85	62.96
5	Construction Firms	45	40	88.88
6	Plantation Firms	42	41	97.61
7	Industrial Products Firms	263	144	54.75
Total		875	543	62.05

**Source:** Website of Bursa Malaysia as at June 28, 2013. <sup>1</sup>Population is calculated after excluding financial and banking and insurance and utilities firms. <sup>2</sup>Sample is calculated after excluding the firms with missing data more than three years.

## Measures

Table 2: Single-item Construct for Firm's Performance

Construct	Related items	Measurement/ Source
Firm Performance	Market based measure	<p><u>Measurement:</u>                      Tobin's Q ratio = (Market Value of Preferred Shares + Market Value of Common Stocks + Book Value of Liabilities) / Book Value of Total Assets.</p> <p><u>Sources:</u>                      (Attig <i>et al.</i>, 2009; Grosfeld, 2009; Gutierrez and Pombo, 2009; He and Wang, 2009; Christensen <i>et al.</i>, 2010; Liew <i>et al.</i>, 2011; Choi <i>et al.</i>, 2012a; Luo <i>et al.</i>, 2013)</p>
Accounting conservatism	Accrual-Based Conservatism (ACCRCON)	<p>Accruals = [INC + DEPRN - OCF] / TA                      ACCRCON = (Accruals/ 3 years) × (-1)                      (Ball and Shivakumar, 2005; Duellman, 2006)</p>
Audit Committee Effectiveness (ACE)	Audit committee independence (ACI)  Audit committee expertise (ACEx)  Audit committee diligence (ACD)	<p><u>Measurements:</u>  <math>ACE_{it} = \Sigma (ACI_{it} + ACEx_{it} + ACD_{it} )</math>                      ACI = a dummy variable with indicator scheme for firm <i>i</i> is using one (1) if chairman of audit committee is independent director, zero (0) if otherwise.                      ACEx = a dummy variable with indicator scheme for firm <i>i</i> is using one (1) if at least one member of the audit committee has financial professional expertise (e.g. degree in accounting or member of a professional accounting body or work experience - experience as a public accountant, auditor, chief financial officer, chief accounting officer, CEO), otherwise, score is zero (0).                      ACD = a dummy variable with indicator scheme for firm <i>i</i> is using one (1) if during the period <i>t</i> the audit committee conducted <math>\geq 5</math> meetings, otherwise, score is zero (0).                      Firms are classified into 4 group on the basis on above score by the variable of interest i.e. score 0 indicates no ACE, score 1 for somewhat ACE, score 2 for good ACE, and score 3 for very good ACE.</p> <p><u>Sources:</u>                      (DeFond <i>et al.</i>, 2005; Dhaliwal <i>et al.</i>, 2006; Krishnan and Visvanathan, 2008; Steward and Munro, 2007).</p>

<p>External Auditor Quality (EAQ)</p>	<p>Auditor 's independence (AI),                  Auditor's specialization (AS), and                  Auditor's brand name (ABN)</p>	<p><math>EAQ_{it} = \Sigma (AI_{it} + AS_{it} + ABN_{it} )</math>  <i>AI</i> = a dummy variable with indicator scheme for firm <i>i</i> is using one (1) if during time period <i>t</i> the ratio of non-audit fees to total fees paid to the external auditor is less than 20%, otherwise, score is zero (0).  <i>AS</i> = a dummy variable with indicator scheme for firm <i>i</i> is using one (1) if auditor during time period <i>t</i> is recognized as an industry specialist for auditing purposes in the industry sector to which firm <i>i</i> is categorized by Bursa Malaysia, otherwise, score is zero (0).  <i>ABN</i>= a dummy variable with indicator scheme for firm <i>i</i> is using one (1) if the auditor engaged is one of <i>Big 4</i> major leading international accounting firms (i.e. Price Waterhouse Coopers, Deloitte and Touché, KPMG and Ernst and Young), otherwise, score is zero (0).                  Sources:                  (Rapani, 2011; Myers, Myers and Omer, 2003; Choi and Doogar, 2005; Ghosh and Moon, 2005; Basioudis, Papakonstantinou and Geiger, 2008)</p>
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## Data Analysis

### Correlation Analysis

The Pearson correlation coefficients are computed to explore the relationship between the audit committee effectiveness, external auditor quality, accounting conservatism and firm's performance variables before conducting the regression as well as examining the issue of multicollinearity. Table 3 provides correlation matrices for four observed variables used in this study. The correlation matrices show that immediate effects of accrual based conservatism, timeliness based conservatism which stems from the foundation of this study are found to be non-significant with audit committee effectiveness and external auditor quality, providing primary evidence that these variables are unrelated with criterion variables which means there is no effect of audit committee effectiveness and external auditor quality on degree of conservatism. Therefore, authors moved on 1-year-lagged effect of audit committee effectiveness and external auditor quality on criterion variables (accrual based conservatism and market based firm performance) but found insignificant relation. Finally, authors found significant relation with only two-year-lagged effect which support the idea diffusion hypothesis of Hong et al. (2007) who have stated that managers underreact the information and they reported that managers are 'momentum traders' and 'news watchers'. They (Hong et al., 2007) documented that a news watcher cannot extract the information from the prices of other news watcher since they observes some private information. On the other hand, the values of correlation are between 7% to 31% which is significantly less than level where there is presence of a problem of multicollinearity (i.e. > 90%) (Tabachnick & Fidell, 2007).

Table 3 shows that the highest correlation is between accrual-based conservatism (ACCRCON) and asymmetrical timeliness conservatism (ATCON) at 31.60%. Hence, there is no problem of multicollinearity among independent, mediating and dependent variables in this study.

Table 3: Correlation Analysis

Correlation analysis of immediate effect				
Variable	1	2	3	4
ACE	1			
EAQ	0.078	1		
ACCRCON	0.044	0.007	1	1
MPER	0.008	0.012	0.231	0.118
Correlation analysis effect of one-year-lagged effect				
ACE	1			
EAQ	0.078	1		
ACCRCON	0.032	0.002	1	1
MPER	0.011	0.033	0.231	0.118
Correlation analysis effect of two-year-lagged effect				
ACE	1			
EAQ	0.078	1		
ACCRCON	0.119	0.152	1	
MPER	0.119	0.108	0.231	0.118
Correlation analysis effect of three-year-lagged effect				
ACE	1			
EAQ	0.078	1		
ACCRCON	0.001	0.111	1	
MPER	0.086	0.044	0.231	0.118

Correlations in bold represent significance at 5% or less

Note: ACE = audit committee effectiveness, EAQ = external auditor quality, ACCRCON = accrual based conservatism, MBFP = market based firm's performance

### *Normality Test of Study Variables*

Table 4 shows significant relations among study variables with two-year-lagged effect of audit committee effectiveness and external auditor quality. Therefore, this study is conducted on two-year-lagged effect on accrual-based measure of conservatism and firm's market based performance. Checking the normality of data is the basic assumption of both factor analysis and structural equation modeling (Kline, 2005). Normality of all study variables was examined by screening the data through the skewness and kurtosis test as shown in table 4. The distribution is considered to be normal if the skewness and kurtosis values fall between the range of +3 to -3 (Tabachnick & Fidell, 2001). Therefore, the results of skewness and kurtosis validated the normality of symmetry and peakedness of the distributions. These findings show that entire data are within the normal range and the distributions were close to normal (see Table 4).

Table 4: Skewness and Kurtosis Test

Variable	Skewness	SE	Kurtosis	SE
Lag2_ACE	1.113	0.122	1.995	0.102
Lag2_EAQ	0.777	0.122	1.774	0.102
ACCRCO	-1.333	0.122	2.856	0.102
MBPER	-0.886	0.122	1.971	0.102

Note: ACE = audit committee effectiveness, EAQ = external auditor quality, ACCRCO = accrual based conservatism, MBFP = market based firm's performance

*Constructs Used in this Study-Measurement Model (First Stage)*

For two-year-lagged effect, this study is conducted a series of CFAs (confirmatory factor analysis) to obtain the best model fit among five variables. Initially, this study performed a CFA on a four-factor model of independent and dependent variables without any modification, which resulted in these fit values:  $\chi^2 = 10.32$ ,  $p < 0.02$ ,  $\chi^2 / df = 2.58$ , RMSEA = 0.06, RMR= 0.04, CFI = 0.99, GFI = 0.97 (Figure 2). Therefore, the results of the three-factor model without any modification fit the data well.

Table 5: Fit Indices of CFA for Study Variables

Model	$\chi^2$	df	$\chi^2/df$	RMSEA	CFI	GFI	NFI	AIC
Model 1: 4-factor	10.32	4	2.58	.060	.99	.97	.94	112.06

Note:  $\chi^2$  = Chi-square; df= Degree of Freedom;  $\chi^2/df$  = Normed-Chi square; RMSEA= Root Mean Square Error of Approximation; CFI= Comparative Fit Index; GFI= Goodness of fit index; NFI= Normed Fit Index; AIC= Akaike Information Criterion

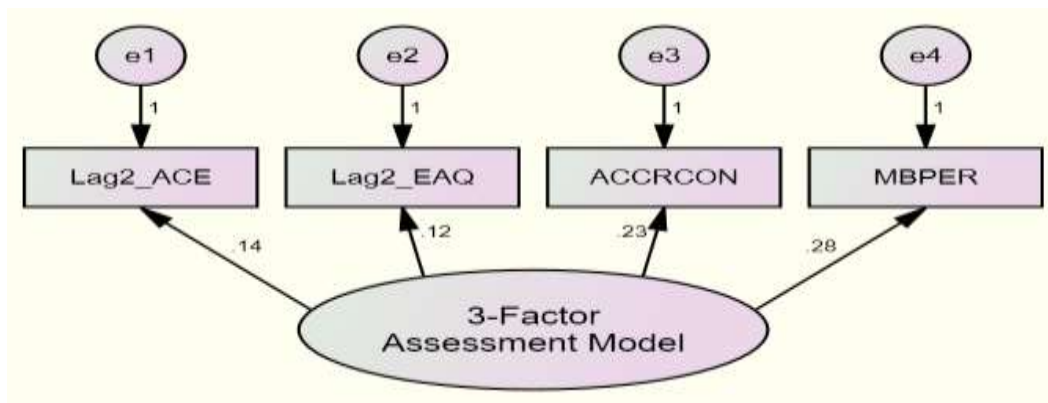


Figure 2: Measurement Model

*Structural Model of Study*

Hypothesized analyses were observed through structural model among audit committee effectiveness, external auditor quality, accrual based conservatism, and firm’s market based performance with five paths are shown in figure 2.

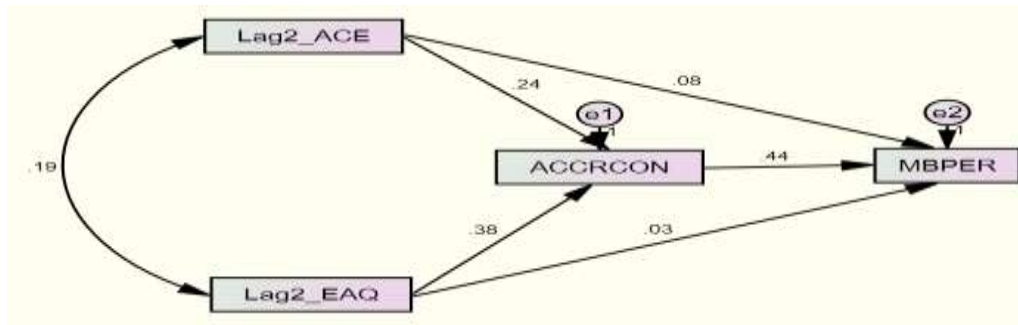


Figure 3: Hypothesized Structural Model

**Values of model fit:**  $\chi^2 = 12.67$ ,  $df=6$ ,  $\chi^2/df=2.113$ ,  $p=0.00$ ,  $NFI=0.95$ ,  $GFI=0.932$ ,  $IFI=0.911$ ,  $AGFI=0.898$ ,  $CFI=0.900$ ,  $TLI=0.897$ ,  $RMSEA=0.067$

Table 6: Results of Hypotheses Testing

Hypotheses	Paths	$\beta$	C.R	$p$	Supported
H1	ACE-ACCRCON	.233	4.121	.000**	Yes
H2	EAQ- ACCRCON	.377	3.865	.000**	Yes
H3	ACCRCON-MBPER	.442	6.143	.010**	Yes
H4a	ACE-MBPER	.082	0.144	.120	NOT
H4b	EAQ-MBPER	.0311	0.332	.261	NOT
H5a	ACE- ACCRCON-MBPER	.24x.44 = 0.11			Yes
H5b	EAQ- ACCRCON-MBPER	.38x.44 = 0.1675			Yes

Note: ACE = audit committee effectiveness, EAQ = external auditor quality, ACCRCON = accrual-based conservatism, MBPER = market-based performance, \*\* $p < .001$ , \* $p < .05$

Standardized estimates along with the values of model fit are identified in figure 2. The values of model fit (i.e.  $\chi^2 = 12.67$ ,  $df=6$ ,  $\chi^2/df=2.113$ ,  $p=0.00$ ,  $NFI=0.95$ ,  $GFI=0.932$ ,  $IFI=0.911$ ,  $AGFI=0.898$ ,  $CFI=0.900$ ,  $TLI=0.897$ ,  $RMSEA=0.067$ ) are identifying that the model is good fit, with two insignificant paths which required modification (Hair et al., 2010). These findings show that audit committee effectiveness and external auditor have significant effect on degree of conservatism with two-year-lagged effect. In addition, accrual based conservatism found significant in mediating relationship between audit committee effectiveness and external auditor with firms market based performance.

## Discussion

The first proposition “audit committee effectiveness influence positively relates to degree of accrual-based conservatism”. The empirical results of the study (2-year-lagged) showed significant association between audit committee effectiveness and accrual-based conservatism with slope coefficient for  $H_1$  (i.e.  $\beta = .233$ , t-statistics = 4.121,  $p = .000$ ). This robustness and sensitivity tests strongly support the positive significant association highlighted by the SEM results, which is in line with predictions. Accordingly, given the above findings from the two analysis steps and that most of robustness and sensitivity tests are aligned to expectations;  $H_1$  is therefore supported. Similarly, the second proposition is hypothesized as “external auditor quality influence positively to degree of accrual-based conservatism”. The findings about external auditor quality in this study found to be significant effect (i.e.  $\beta = .377$ , t-statistics = 3.865,  $p = .000$ ) with accrual-based conservatism, which show that Malaysian firms recognize and external auditor quality as a signal and create more accrual to protect stakeholders by adopting higher degree of conservatism. Therefore, these results strongly support hypothesis  $H_2$ .

These findings with two-year-lagged effect corresponds to immediate effect of prior empirical studies on firm’s corporate governance mechanisms that found significant links between audit committee effectiveness and conservative accounting policies (Ahmed & Duellman, 2007; Garcia Lara et al., 2009; Krishnan & Visvanathan, 2007). However, these finding contradicted the results of Yunos (2011) who conducted a study on panel data on Malaysian companies observed over 7 years from 2001 to 2007, considering three characteristics of audit committees - committee composition, financial expertise, and committee meetings. Yunos found no association between audit committee effectiveness and a firm’s degree of conservatism; her results are consistent with Abdullah et al.’s (2010) and Rapani (2011), as these researchers also found inconclusive findings. They further stated that an increase in the proportion of independent directors on the audit committee led to a higher probability of financial misstatement. Similarly, Yunos’s (2011) and Rapani (2011) contradicting results between audit committee compositions suggest that these two mechanisms reacted differently toward conservatism practices. However, this study found the strong support of association with two-year-lagged effect between audit committee effectiveness and conservatism. The inconsistency between prior Malaysian studies and the current study might be caused by a time lagged effect and or might be related to factors concerning the implementation of Malaysian corporate governance code 2007 through Malaysian Institute of Accountants (MIA). These findings correspond with prior empirical studies (Francis et al., 1999; Cahan and Zhang, 2006; Chung et al., 2003; Pae et al., 2003; Ahmed and Duellman, 2007; Krishnan, 2007; Krishnan & Visvanathan, 2007; Qiang, 2007) on external auditor’s influence and conservative accounting policy that found positive and significant factors that influence managers in formulating and reshaping conservative accounting policies. In support of reputation theory, Cahan and Zhang (2006) and Krishnan (2007) provided support to auditors of ex-Andersen clients to lessen their risk of litigation. Cahan and Zhang (2006) found discretionary or lower abnormal accruals in clients of ex-Andersen as compared to a corresponding sample. The clients of ex-Andersen were prospected as a unique form of litigation risk and their own reputational capital. Francis et al. (1999) found that firms have more tendencies to hire big auditor firms if they have higher levels of accruals for

providing an indication that these accruals are plausible and catch the attention of more internal and foreign investors. Study findings support Watts & Zuo (2011) who have suggested that conservatism constrains managers' ability to increase current net assets and earnings and provide earning quality. In addition, conservatism also restricts managers not to undertake negative NPV projects because these projects decrease current earnings and when managers abandon negative NPV, the earning per share increase which leads to higher firm's market performance. Conservatism identifies economic losses through various signals more quickly and gives a positive signal to market by protecting the property of stakeholders (Watts & Zuo, 2011). Therefore, conservatism benefits market based firm's performance by limiting operation of negative NPV projects (Watts & Zuo, 2011). The results of accrual-based conservatism (i.e.  $\beta = .441$ ,  $t$ -statistics = 6.142,  $p = .010$ ) are found to be highly significant and are consistent with market-based firm's performance, which clearly reflect that Malaysian firms are more sensitive to transform accrual based conservative policy into stock market returns. This study supports efficient market hypothesis. Therefore, these results support hypothesis H<sub>3</sub>.

To find the mediating role of accrual-based measure of accounting conservatism (figure 1) between the relationship of audit committee effectiveness and external auditor quality with market-based firm's performance, this study found significant full-mediation. It means that ACCRCON perform the role of mediator on the relationship between ACE and EAQ with MBPER. These findings support the reputation theory to reduce in litigations risks/costs and it serves as an important motivation for higher quality monitoring by audit committees and external auditor quality. Past studies (Watts 2003b; Lara et al. 2009a; Lara et al. 2009b) reported that conservatism benefits in retaining reputational capital by reducing litigation risk to follow signaling theory. Therefore, it is more likely that an effective audit committee will engage in conservative accounting practices so that the reputational damage and threat of litigation can be prevented. The current study findings are significant with two-year-lagged effect with the reasons that the followers of lagged effect advocate that managers in short horizon underreact whereas; over the long horizon they overreact to the information (Barberis et al., 1998; Hong and Stein, 1999; Poteshman, 2001; Khan, 2014). This hypothesis dictates that managers/investors do not respond strong enough to the new endogenous and exogenous factors. In this sense, since the strong reaction by the managers take time; therefore, information displays their effect after some time. This study found strong support of two-year-lagged effect of endogenous and exogenous factors on accrual-based conservatism and asymmetrical timeliness conservatism, therefore, this study supports the signaling theory as lagged effect. Now the question is why there is delay effect on degree of conservatism? The answer of this question is diffusion hypothesis of Hong et al. (2007) who have stated that managers underreact the information and they said further that managers are 'momentum traders' and 'news watchers'. They (Hong et al., 2007) documented that a news watcher cannot extract the information from the prices of other news watcher since they observe some private information. This leads to the gradual information diffusion hypothesis which this study justifies in Malaysian listed firm. In addition, Barberis et al. (1998) stated in their "limited information processing capacity hypothesis" that most of the managers do not pay full attention (or may have less capacity to absorb information) to the publically available information. Therefore, in this way the



lagged effect become more forceful as compared to immediate effect which is supported through this study.

## **Implications**

First, the theory of litigation risk postulates that the firm litigation risk from overstating earnings is substantially higher than the risk from understating earnings (e.g. see Basu, 1997; Ball et al., 2000; Watts, 2003a; and Bushman & Piotroski, 2006). The debt-contracting theory develops due to the efficient contracting solution to cope with the agency conflict (between debt holders and shareholders) (see Watts, 2003a; Ball et al., 2008; Beatty et al., 2008; and Zhang, 2008). Similarly, according to the managerial contracting theory, conservatism is an efficient contracting mechanism that may offset (fully or partially) the opportunistic attitude of the managers of the firms who always try to overstate the earnings with the intension of rising their own compensations (Kwon et al., 2001; Watts, 2003a; Lara et al., 2016).

Second, positive accounting theory advocates that conservatism is a resourceful governance mechanism to mitigate conflicts and address agency problems between shareholders and bondholders (Watts, 2003a; LaFond & Roychowdhury, 2008; LaFond & Watts, 2008). Past research has offered empirical evidence of the economic benefits of conservatism to debt holders (Ahmed et al., 2002; Beatty et al., 2008; Zhang, 2008). Nonetheless, there is little evidence for the benefits of conservatism to shareholders. In fact, shareholders are the main stakeholders of a company, and empirical evidence regarding the impact of conservatism on shareholder worth is vital for the sustainability of company (Wu et al., 2013). Investigating the economic significance of conservatism on shareholder wealth could also benefit the ongoing debate on the costs and benefits of conservatism. With respect to the costs and benefits of conservatism, Watts (2003a) LaFond and Roychowdhury (2008), LaFond and Watts (2008), documented that under information asymmetry, managers get the opportunity to manipulate the value of net assets and earnings so as to report their efficiency, and to maximize their personal benefits because of the separation of ownership from the control of the company. Conservatism reduces this management resourcefulness by applying a reasonable degree of verification to recognize good rather than bad economic news (Basu, 1997; Watts, 2003a). To sum up, LaFond and Watts (2008) reported that conservative financial reporting is a governance mechanism that reduces the manager's ability to manipulate and overstate financial performance and increases the firm's cash flows and firm's market-based performance.

More precisely, this study reveals whether the "signaling theory", "debt-contracting theory", "managerial-contracting theory", "litigation risk theory" and "reputation theory" assertion is supported in an emerging economy such as Malaysia or not. The findings of this study highlight the gap between theories and Malaysian practices with a new operational definition of conservatism at the end.

"Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainty and risk inherent in business situations are timely and adequately considered and are timely and accurately communicated to person concerned".

## Limitations of Study

This section focuses on some limitations of this study.

First limitation of this study is that it only covers a 10-year observation window (i.e., 2004 to 2013) and Malaysian Financial Reporting Standards has been implemented properly after 2011. Thus, the limitation revolves around generalizing results to time periods prior to 2011. In such studies, the quality of the data is affected because variations in one period to other may affect other findings (Podsakoff et al., 2000). Therefore, the variation in the data during different Malaysian Corporate Governance (MCCG 2000, 2007, 2012 and 2017) is not considered.

Second, this study used data from a single emerging economy. While prior empirical research (Basu, 1997; Dhole, 2010; Wong et al., 2009; Jeffrey et al., 2014; Lara et al., 2016) provided evidence of conservatism. Theoretic arguments concerning accounting conservatism and factors that may influence conservative accounting policies have been developed in efficient capital market.

The third issue is to estimate the accuracy of the estimated discretionary accruals. Many studies, including Healy and Wahlen (1999) and Dechow and Skinner (2000), have questioned the effectiveness of the existing discretionary accruals models. This study employed the modified Jones (1991) model to measure discretionary accruals, as adopted by Ball and Shivakumar (2005). To the extent that this model faithfully characterizes discretionary accruals, this researcher's model is successful in measuring conservatism in pre-managed earnings. However, it still leaves open the possibility of including some effects of earnings management in the conservatism model while measuring the construct validity of seven measures of accounting conservatism.

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