

## The Effect of Audit Committees Characteristics on Accounting Conservatism Practices for Companies Listed in Egyptian Stock Market

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### المخلص :

يهدف هذا البحث إلى دراسة اثر خصائص لجان المراجعة على ممارسات التحفظ المحاسبي في الشركات المقيدة بسوق الأوراق المالية المصري. تقوم هذه الدراسة على خمس خصائص للجان المراجعة (الاستقلالية، الخبرة المالية، النشاط، حجم لجان المراجعة، تعدد عضويات أعضاء لجان المراجعة)، كما يقوم الباحث بقياس التحفظ المحاسبي باستخدام نموذجين: نموذج التوقيت الغير متمائل (Khan & Watts, 2009) ونموذج الاستحقاقات (Givoly & Hayn, 2000). هذا وتتكون عينة الدراسة من ٤١ شركة من الشركات المقيدة بسوق الأوراق المالية المصري وذلك لفترة خمس سنوات من ٢٠٠٩ وحتى ٢٠١٣، بحيث تقوم هذه الدراسة على تحليل الانحدار وذلك باستخدام برنامج SPSS. وفيما يتعلق بالنتائج، فقد أظهرت الدراسة وجود علاقة موجبة ذات دلالة معنوية بين كلا من استقلالية ونشاط لجان المراجعة وبين التحفظ المحاسبي وذلك وفقا لكلا النموذجين (نموذج التوقيت غير المتمائل ونموذج الاستحقاقات). بينما أظهرت النتائج وجود علاقة موجبة بين الخبرة المالية للجان المراجعة وبين ممارسات التحفظ المحاسبي باستخدام نموذج التوقيت الغير متمائل فقط. وفيما يتعلق بحجم لجان المراجعة وتعدد عضويات أعضاء اللجان، فقد أظهرت النتائج عدم وجود علاقة تربط بين هذه المتغيرات وبين التحفظ المحاسبي. ووفقا لهذه النتائج فان هذا البحث يدعم العلاقة التكاملية بين حوكمة الشركات والممثلة في خصائص لجان المراجعة وبين ممارسات التحفظ المحاسبي، والتي يمكن تفسيرها من خلال دعم الدور الحوكمي للتحفظ المحاسبي.



**Abstract :**

This study examines the relationship between audit committees governance role and accounting conservatism. Five audit committee characteristics have been examined including (independence, financial expertise, size, diligence and members' multiple directorships). Conservatism has been measured using two models, the asymmetric timeliness measure (Khan & Watts, 2009) and the accrual based measure (Givoly & Hayn, 2000). The study sample consists of 41 Egyptian listed companies of the most active 50 companies over a time period of five years from 2009 to 2013. The study depends on multiple linear regression analysis using the SPSS software. The study results have shown that audit committees independence and diligence are positively associated with accounting conservatism whether measured by the asymmetric timeliness model or the accrual based one. The audit committee financial expertise also show a significant positive association but only with the asymmetric timeliness measure. Both the audit committee size and members multiple directorships doesn't show a significant relationship with accounting conservatism through both models. The study results support the complementary relationship between audit committee characteristics and conservatism, and provide evidence regarding the governance explanation of accounting conservatism in the Egyptian context.

**• Introduction & Research problem**

During the recent years, one of the vast areas toward which the academic societies have shown great attention is the issue of agency and managers motivation toward transfer of corporate capital and value to their own ultimate profit. Managers of corporation effectively control the corporation's assets while they don't have the ownership of major shares of that corporate.

This increasingly clear separation of ownership from management represented in numerous ways, including manipulation of financial information, accounting frauds and expropriation of wealth. The consequences of these conflicts and the several recent financial scandals that take place in the United States and Europe have raised the need to install an appropriate framework for corporate governance to fight against the opportunistic behaviors that have undermined investors' credibility in financial information.

On the other side Conservatism is one of the most prominent characteristics of financial accounting that has influenced accounting practices for centuries and is associated with the contracting role of accounting. Since managers often have an incentive to manipulate earnings upward, accounting conservatism appear as a limitation which causes managers to decrease both the potential and tendency to behave opportunistically through requiring higher verification

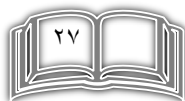
standards for gain than for losses, which reduces managers ability to withhold information about expected losses.

According to the role played by accounting conservatism, we can say that the quality of the corporate governance system dramatically influences on conservatism applied in the financial reports. We predict that adequate governance results in better monitoring of management and hence will favor the implementation of conservative accounting to fulfill its monitoring role. In other words we argued that strong corporate governance mechanisms increase conservatism in financial reporting as a governance tool.

Recently corporate governance codes in many countries have empowered the role of audit committees in the oversight of financial reporting and ensuring high quality accounting information (e.g. UK Code, 2014). An effective audit committee has been used in many literature as a vital component of an effective corporate governance system. In supporting for regulations and prior studies, this study will focus on audit committee as a representative of internal governance mechanisms.

As an overview, the current study try to evaluate the effect of internal governance system on conservatism practices in companies listed in the Egyptian market, using:

1. Internal corporate governance mechanisms as independent variable: audit committee characteristics



are used as internal governance mechanism, that consists of five variables including (independence, financial expertise, diligence, size, member's multiple directorships).

2. Conservatism as the dependent variable: which is measured using two models: 1) the asymmetric timeliness (Khan & Watts, 2009); 2) the accrual-based (Givoly & Hayn, 2000)
- 3.

**Given the issues raised above, the study main question can be summarized as follows:**

Does the effectiveness of the audit committee as an internal corporate governance mechanism affect accounting conservatism practices for companies listed on the Egyptian Stock Exchange?

**To give an answer on the before formulated research main question the next sub questions are developed:**

1. What are the definitions of the terms corporate governance, audit committee and accounting conservatism?
2. Does the concept of accounting conservatism still survive in financial reports of the Egyptian listed companies?

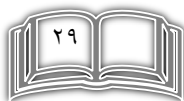
3. What are the characteristics of audit committee that support strong corporate governance structure?
4. What does evidences tell so far about the relation between corporate governance and accounting conservatism?

- **Research objectives**

The main objective of the study is to investigate the impact of the audit committee characteristics governance role on conservatism practices for companies listed in the Egyptian Stock Exchange.

**The following sub-objectives also could be derived:**

1. To measuring accounting conservatism for companies listed in the Egyptian Stock Exchange and display reasons behind raise the needs for conservatism.
2. To recognize the monitoring role of audit committee in oversight financial reporting, and determine the characteristics of audit committee that restrain the management opportunistic behavior and support strong governance structure.
3. To examine the relationship between audit committee characteristics including (independence, financial expertise, diligence, size, multiple directorships) and accounting conservatism practices.



- **Research Significance**

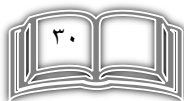
The significance of this study can be clearly noticed through both the following academic and the practical importance:

- **Academic Aspect**

The study provides the first empirical evidence relating to the relationship between audit committee governance role and conservatism in Egyptian companies that has a different work environment than US and UK. In addition, our study is the first study that focuses on audit committee multiple directorships phenomenon in the Egyptian context.

- **Practical Aspect**

1. This study will help policy makers to evaluate the applicability of the current corporate governance practices especially for audit committee for Egyptian listed companies, and to identify whether the corporate governance code in Egypt need to be modified.
2. The study attract the attention to the regulatory debate on whether conservatism should be excluded from the desirable qualitative characteristics of accounting information.
3. Since conservatism is argued to be useful and needed from many users, it is important for these users to understand the factors that influence the company's use of accounting conservatism.



### ▪ **Research Hypotheses**

Based on the objectives of the current study the following hypotheses are developed:

**H1:** Audit committee Independence is positively associated with accounting conservatism.

**H2:** Audit committee financial expertise is positively associated with accounting conservatism.

**H3:** Audit committee diligence is positively associated with accounting conservatism.

**H4:** Audit committee size is positively associated with accounting conservatism.

**H5:** Audit committee members multiple directorships is positively associated with accounting conservatism.

### ▪ **Structure of the Study**

The remainder of this study is organized as follows: first, the theoretical framework, which presents background of the main variables in this study which including 1) corporate governance and audit committee as an internal governance mechanism; 2) accounting conservatism; 3) the relationship between corporate governance and accounting conservatism. Second, the empirical study was included which depending on regression analysis.

#### **1. Theoretical Framework**



### **1.1. Corporate Governance and Audit Committee as an Internal Governance Mechanism**

According to the world wide accounting scandals that take place in the United States and Europe, the investors lost their confidence in the integrity of financial statements. These scandals induced the regulators to proposed more strictly regulations of corporate governance on a trial to regain investor confidence.

Although a number of previous studies have discussed the concept of corporate governance (e.g. Armstrong, C. et al., 2010; Kangarluei, S. et al., 2011; Foroghi, D. et al., 2013), delineating what corporate governance exactly means is not straightforward. Therefore there is no unique definition for the corporate governance concept.

Also there is no generally accepted definition for the corporate governance concept, it has also been more widely used as the set of mechanisms which used to mitigate the agency problem that arise between shareholders and managers due to the separation of ownership and control (Shleifer & Vishney, 1997; Armstrong, C. et al., 2010; Foroghi, D. et al., 2013).

The OECD corporate governance guidelines are considered internationally agreed benchmark that are often used by countries to develop their own local codes. According to (OECD, 2015) corporate governance is defined as “a set of

relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined".

Owing to the conflicts that resulting from the separation of ownership and control, (Kangarluei, S., 2011) admitted that in the modern business world a system of corporate governance is necessary, through which management is supervised to reduce the agency costs and align the interests of management with those of the shareholders.

Researchers often categorize corporate governance mechanisms into two categories, internal and external mechanisms (Man & Wong, 2013; Zahran, E., 2013; Dharmastuti & Wahyudi, 2013). While regulators concentrate on internal mechanisms, in practice external mechanisms are also important (Agrawal & Knoeber, 1996).

The corporate governance mechanisms that are the focus of recent regulations and prior studies are attributes related to the organization and functioning of the board in general and its audit committee in particular (Lin, J. & Hwang, M., 2010). Corporate governance codes in many countries have empowered the role of the audit committee in the oversight of financial reporting and ensuring high quality accounting information (e.g. the UK Code, 2014).



(Bédard & Gendron, 2010) showed that there are two ways through which the audit committee can achieve its goal and improve the quality of information: (1)the direct way: by monitoring the financial reporting process itself, (2)the indirect way: through a) the oversight of internal control (including internal auditing); b) the oversight of external auditing (selection, compensation, work, and independence of the external auditor).

The mere existence of an audit committee, does not guarantee high quality financial reporting practices. Several literatures admit that the specific characteristics of the audit committee influence the main functions assigned to it. Those literatures suggest that the effective oversight role of the audit committee is enhanced when the audit committee is well structured and has a moderate level of experience. This study focus on five characteristics of audit committee including independence, financial expertise, meetings frequency, size and members' multiple directorships.

## **1.2. Accounting conservatism**

Conservatism is one of the most prominent characteristics of financial accounting, its practices have been the subject of a long standing debate as to how they affect the quality of the financial statements. Discussion on conservatism has appeared in the literature since the 1920 and

continues to the present. Despite the important position that conservatism has in accounting practices, it is noted that there is a lack in a formal definitions for this concept. This limitation on legal entities definitions open the door for accountants, academics and researchers to searching deeply in this concept.

In this range conservatism is defined by (Basu, 1997) as “a technique which produces earnings that reflect bad news in a timelier fashion than good news through imposes stronger verification requirements for the recognition of gains than for losses”. (Givoly& Hayn, 2000) also define conservatism as “a selection criterion between accounting principles that leads to the minimization of cumulative reported earnings by slower revenue recognition, faster expense recognition, lower asset valuation and higher liability valuation”.

From the literature, the origin of the concept accounting conservatism and the need for its practice is derived through four factors within accounting texts including contracting, litigation, taxation and regulation (Watts, 2003).This factors called explanations.

According to (Lu, X., 2012; Foroghi, D. et al., 2013; Petruska & Wakil, 2013) contracting is an early explanation for conservatism. Under the contracting explanation, conservatism is used mainly to mitigate the information asymmetry between different parties such as management and



stakeholders. Management often has more information about the firm than the stakeholders, which creates a risk that they will overstate profits for their own benefits at the expense of the other stakeholders. Conservatism comes to prevent this practices, and constrain the management opportunistic behavior through recognize loss in a timelier way than profit.

The second explanation for conservatism is a shareholder litigation. According to (Hwang, C. et al., 2014) litigation is deemed to persist more on occurrences of overstatements rather than understatements. (Petruska & Wakil, 2013) told that the asymmetry of litigation costs leads firms to choose conservative accounting to reduce earnings if they are faced with high litigation costs.

According to (Petruska & Wakil, 2013) accounting principles can be changed which produce a change in tax liability for firms. The asymmetric recognition of losses and gains due to accounting conservatism in financial reporting can affect taxes paid by firms. Consequently profitable firms can decreasing their earnings through the use of conservatism to reduce or defer their taxes (Petruska & Wakil, 2013; Hwang, C. et al., 2014).

The last explanation for accounting conservatism is the standard setters and regulatory explanation. The political costs to these non-contracting parties (standard setters and regulators) are higher if firms overstate, rather than understate



net assets because overstatements will be more visible to investors and outsiders (Petruska & Wakil, 2013). Thus, in order to reduce political costs, standard setters and regulators demand conservatism.

The evidences also showed that conservative reporting is effective regarding limits managers' opportunistic behavior and reduce managers incentives to manage earnings (García Lara et al., 2012), enhancing firm value (Suijs, J., 2008; Ross, L. & Luo, Z., 2011), reducing the likelihood of a firm's future stock price crashes (Kim, J. & Zhang, L., 2016), having less earnings forecasting error (Ahmad, L. & Meysam, H., 2010), facilitating the monitoring of debt-contracts and reducing the cost of debt (Beatty et al., 2012).

### **1.3. The Relationship between Corporate Governance and Accounting Conservatism**

The important role of corporate governance and conservative accounting in facilitating efficient contracting causes a link between them (Foroghi, D. et al., 2013). Many studies have been made regarding both conservatism and corporate governance separately in different countries. However, the first study that investigated the association between corporate governance and conservatism is conducted in UK firms by (Beekes et al., 2004).

(Beekes et al., 2004) used earnings timeliness and conservatism as a proxy for accounting quality. The study focus on board of directors composition as a proxy for governance system. Results indicated that firms with a higher proportion of outside board members are more likely to recognize bad news in earnings on a timely basis. However, firms whose boards comprise a relatively high proportion of outsiders do not display greater reporting conservatism with regard to the recognition of good news.

During the last decade (Yunos, R. et al., 2011) also examined the relation between board of directors and accounting conservatism. They stated that board of directors are responsible for reviewing the adequacy and integrity of financial reporting system and are accountable to the stakeholders for firm performance. Therefore, they expected that board of directors will demand more conservatism to assist them in the governance role. Consistent with the expectations, the study found a positive relation between board of directors characteristics and accounting conservatism.

In this regard (Ahmed, K. & Henry, D., 2012) added that accounting conservatism is one of a multitude of available agency and governance mechanisms, and that firms select an optimal governance framework based on their underlying agency environment. The study empirical results supported



the contention that firms voluntarily adopting perceived best practice corporate governance mechanisms employed unconditional accounting conservatism as a complimentary agency control device. On the other side, best practice corporate governance found to be negatively related to the degree of conditional conservatism which promote the substitutive effect.

In a trial to interpret the previously mentioned results, theoretically, some studies have showed that there are two perspectives that interpret the relation between corporate governance and accounting conservatism (e.g. Foroghi, D. et al., 2013; Hwang, C. et. al., 2014). (Hwang, C. et al., 2014) depicted the foregoing theoretical relationship that rationalize the demand for accounting conservatism by considering two behavioral frameworks.

According to the first perspective, conservatism is considered as an instrument to reduce uncertainty and information asymmetry. In the case of a weak corporate governance structure brought about by traditional agency, the extent of conservatism practices may increase as the need to curb opportunism arises, specifically in terms of managerial contracting. This perspective presented the substitutive relationship between corporate governance and accounting conservatism that supported by traditional agency theory. This





is also referred to as the demand side of accounting conservatism.

The second perspective adopts the stewardship theory that justifies the supply side of accounting conservatism. This perspective calls for the altruistic behavior of managerial agents towards the benefit of owners. Accordingly it suggests that a firm with a strong corporate governance mechanism would be expected to provide more conservative financial reports with aim of mitigating litigation, taxation, and regulation costs for the firm. This is logically referred to as the complementary perspective.

Taken together, the researcher noted that there are many studies that investigated the relation between corporate governance and conservatism in different countries (e.g. Beekes et al., 2004; Shahan, M., 2010; Kangarluei, S., 2011; Yunos , R., 2011; Nahandi, Y. et. al., 2012; Sharifi, R. et. al. , 2013; Hwang, C. et al., 2014). These studies could be conducted depending on one of two points of view.

According to the first point of view, conservatism is used as a proxy for accounting quality or earnings quality through the asymmetric timeliness measure of conservatism. The second point of view investigate the relation between corporate governance and accounting conservatism to prove or deny the governance explanation of accounting conservatism. This governance role of conservatism can be



proven through the substitutive (e.g. Hwang, C. et al., 2014) or the complementary (e.g. Foroghi, D. et. al., 2013) relation between accounting conservatism and corporate governance.

The studies in such relationship also differ according to the corporate governance mechanisms used, conservatism measures, and the natural of the country the study applied in. Most studies in this field focused on board of directors characteristics as a proxy for corporate governance (e.g. Yunos, R. et al., 2011). Whilst other focused on other mechanisms like ownership structure, audit committee and external auditor (e.g. Kangarluei, S., 2011; Nahandi, Y. et. al., 2012; Sharifi, R. et. al., 2013; Kiryanto, 2014).

## **2. The Empirical Study**

### **2.1. Sample Selection**

The initial sample used in the study is based on the most active 50 companies listed in the Egyptian Stock Exchange during a five year sample period (2009-2013). Banks and financial institutions were excluded from the sample because of particular governance issues imposed by the Central Bank of Egypt. The sample also excludes firms with insufficient data to reach a final sample of 205 firm year observations related to 41 listed companies.

## 2.2. Sources of Data

The most data used in this study were collected manually from companies' annual reports that published in the companies' websites. Other sources include data disclosed in the Disclosure Book for the most active 50 companies in the Egyptian market that issued by Egypt for Information Dissemination Company. Other specialized websites are used which include data bases of listed companies in the EGX. Data on companies' audit committee characteristics were extracted from audit committee report and the board of directors' profile. Some data also was collected from the corporate governance section in company's annual reports.

## 2.3. Variables Measurement

### 2.3.1. Measurement of Independent Variables

- **Audit Committee Independence(AC-IND):** the percentage of independent members to total number of directors in the audit committee.
- **Audit Committee Financial Expertise (AC-EXP):**the percentage of audit committee members with financial expertise to total directors in audit committee.
- **Audit Committee Diligece (AC-DIL):** the number of audit committee meetings held during the year as a proxy for audit committee diligence.

- **Audit Committee Size (AC-SIZ):**the total number of members of the audit committee at year end.
- **Audit Committee Multiple Directorship (AC-MULTI):**the median of the number of outside directorships held by audit committee directors.

### **2.3.2. Measurement of Control Variables**

- **Firm Size (FIRM- SIZ):** the natural logarithm of total assets.
- **Leverage (LEV):** the book value of total debt to the book value of total equity at the end of the financial year.
- **Auditor (AUD):** a dummy variable taking a value (1) for the firm audited by big 4 audit firm and (0) otherwise.
- **Profitability (PROF):** cash flow from operations divided by total assets.
- **Growth (MTB):** is the market value of equity divided by book value of equity.

### **2.3.3. Measurement of dependent Variable**

In this study accounting conservatism represents the dependent variable which measured using the following two models:

### 2.3.3.1. Asymmetric Timeliness Conservatism (CON-AT)

Based on Basu (1997) measure of the asymmetric timeliness method, (Khan & Watts, 2009) proposed a new measure for conservatism called *C-score* model. This model take into account both time series and the cross-sectional variations in conservatism through adding firm-specific characteristics (size, market to book ratio, and leverage) to Basu regression model. The model specify that both the timeliness of good news (*G\_Score*) and the incremental timeliness of bad news (*C\_Score*) are linear functions of firm-specific characteristics and representing as following:

$$G\_Score \equiv \beta_1 = \mu_0 + \mu_1 Size_{it} + \mu_2 M/B_{it} + \mu_3 Lev_{it} \quad (1)$$

$$C\_Score \equiv \beta_3 = \lambda_0 + \lambda_1 Size_{it} + \lambda_2 M/B_{it} + \lambda_3 Lev_{it} \quad (2)$$

where: *Size*: is the natural log of firm total assets; *M/B*: is the market-to-book ratio; *Lev* : is the debt-to-equity ratio; *G\_Score* is the good news timeliness; *C\_Score* is the incremental bad news timeliness (firm-year measure of conservatism). The total bad news timeliness is the sum of *G\_Score* and *C\_Score*.

$$E_{it} / P_{it} - 1 = \beta_0 + \beta_1 R_{it} + \beta_2 D_{it} + D_{it} R_{it} (\lambda_0 + \lambda_1 Size_{it} + \lambda_2 M/B_{it} + \lambda_3 Lev_{it}) + \varepsilon_{it} \quad (3)$$



Where:

$i$  and  $t$  denote firm and time period;  **$Eit / Pit-1$**  : Net Income before extraordinary items divided by beginning of fiscal year market value of equity;  **$Rit$** : Fiscal year share return;  **$Dit$** : Dummy variable equal (1) if returns are less than zero (negative) and (0) otherwise;  **$\beta1$** : Measure sensitivity of earnings to good news (good news timeliness);  **$\beta1 + \beta3$**  : Measure sensitivity of earnings to bad news (bad news timeliness);  **$\beta3$** : Reflecting the incremental sensitivity of earnings to bad news compared to good news (timeliness for bad news over good news).

Then the estimates from equation (3) are applied to equation (2) to obtain the firm specific level of conservatism.

### 2.3.3.2. Accrual-Based Conservatism (CON-ACCR)

According to (Givoly & Hayn, 2000) reverse pattern of accruals occurs when periods in which net income exceeds (falls below) cash flow from operation, is expected to be followed by periods with negative (positive) accruals. (Givoly & Hayn, 2000) examined the income statement effects of conservatism over time and conclude that conservative accounting leads to persistently negative accruals rather than the expected pattern of accrual reversals. Thus, a consistent



predominance of negative accruals across firms over a period of time is an indication of conservatism.

$$\text{Accruals}_{3 \text{ years}} = [(\text{INC} + \text{DEPR} - \text{CFO})] / \text{TA} \quad (4)$$

$$\text{CON-ACCR} = (\text{Accruals} / 3 \text{ years}) \times (-1) \quad (5)$$

Where: *INC*: income before extraordinary items and discontinued operations; *DEPR*: depreciation expenses; *CFO*: cash flows from operation; *TA*: total assets.

## 2.4. Regression Analysis

This section illustrates the two regression models that were used to test the hypotheses as follows:

### 2.4.1. Asymmetric Timeliness Measure of Conservatism (CON-AT) and Audit Committee Characteristics

the main study regression model was employed to test the effect of audit committee characteristics on asymmetric timeliness (CON-AT). Control variables included in this model were auditor and profitability. Firm size, leverage and market to book ratio were excluded from this model to avoid duplication as they are included in (Khan & Watts, 2009) regression model. The regression model can be presented as the following:

$$\text{CON-AT} = \beta_0 + \beta_1 (\text{AC-IND})_{i,t} + \beta_2 (\text{AC-EXP})_{i,t} + \beta_3 (\text{AC-DIL})_{i,t} + \beta_4 (\text{AC-SIZ})_{i,t} + \beta_5 (\text{AC-MII})_{i,t} + \beta_6 (\text{ATID})_{i,t} + \beta_7 (\text{PROF})_{i,t}$$

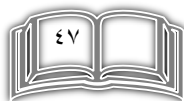


Where :**AC-IND**: Proportion of independent directors to total directors on audit committee;**AC-EXP**: Proportion of audit committee members with financial expertise to total directors on audit committee; **AC-Dil**: Numbers of audit committee meetings held per year; **AC-SIZ**: Number of members of audit committee elected by board of directors; **AC-MULTI**: The median of the number of outside directorships held by audit committee directors; **AUD**: Is a dummy variable, Assigned the value (1) for the firm audited by big 4 audit firm and (0) otherwise; **PROF**: cash flows from operations divided by average total assets.

(Table. 1) provide a summary for the results of the regression model that illustrate the relation between audit committee characteristics and asymmetric timeliness measure of conservatism.

Table. 1: Regression of Asymmetric Timeliness measure of Conservatism(CON-AT) on Audit Committee Characteristics

No	Independent Variables	estimated Coefficient	T-test	F-test	R2	VIF
1	Constant	-0.045	-5.011	7.260***	15.4%	----
2	(AC-IND)	0.028	3.975***			1.102
3	(AC-EXP)	0.011	1.858*			1.019
4	(AC-DIL)	0.003	3.945***			1.345
5	(AC-SIZ)	0.001	0.294			1.459
6	(AC-	0.000	-0.247			1.207





7	MULTI) (AUD)	0.018	5.190***		1.698
8	(PROF)	0.037	1.694		1.085

\* indicates significance at the (.05) level; \*\* indicates significance at the (.01) level; \*\*\* indicates significance at the (.001) level

#### **2.4.2. Accrual-Based Conservatism Measure (CON-ACCR) and Audit Committee Characteristics**

The following empirical model was employed to test the effect of audit committee characteristics on accrual based conservatism measure (CON-ACCR). The accrual based measure of conservatism CON-ACCR is calculated according to equation (5&6) that proposed by (Givoly & Hayn, 2000). The regression model also includ control variables which might have an effect on conservatism practices namely firm size, leverage, growth, auditor and profitability. The regression model can be presented as following:

$$\text{CON-ACCR} = \beta_0 + \beta_1 (\text{AC-IND})_{i,t} + \beta_2 (\text{AC-EXP})_{i,t} + \beta_3 (\text{AC-DIL})_{i,t} + \beta_4 (\text{AC-SIZ})_{i,t} + \beta_5 (\text{AC-MULTI})_{i,t} + \beta_6 (\text{FIRM SIZ})_{i,t} + \beta_7 (\text{LEV})_{i,t} + \beta_8 (\text{MTB})_{i,t} + \beta_9 (\text{AUD})_{i,t} + \beta_{10} (\text{PROF})_{i,t}$$

Where: **AC-IND**: Proportion of independent directors to total directors on audit committee; **AC-EXP**: Proportion of audit committee members with financial expertise to total directors

on audit committee; **AC-DIL**: Numbers of audit committee meetings held per year; **AC-SIZ**: Number of members of audit committee elected by board of directors; **AC-MULTI**: The median of the number of outside directorships held by audit committee directors; **FIRM SIZ**: The natural logarithm of total assets; **LEV**: The ratio of total debt to total equity; **MTB**: Market to book ratio (Market value of equity divided by Book value of equity); **AUD**: Is a dummy variable, Assigned the value (1) for the firm audited by big 4 audit firm and (0) otherwise; **PROF**: cash flows from operations divided by average total assets.

(Table. 2) presents the results of the regression model for audit committee characteristics and accrual based conservatism measure (CONACCR). The reported t-statistics, *F* value, *R* squared and VIF are included.

Table. 2: Regression of Accrual Based Conservatism Measure (CON-ACCR) on Audit Committee Characteristics

No	Independent Variables	Estimated Coefficient	T-test	F-test	R2	VIF
1	(Constant)	-0.091	-1.631	2.432**	12.2%	-----
2	(AC-IND)	0.019	2.846**			1.385
3	(AC-EXP)	0.007	1.154			1.214
4	(AC-DIL)	0.028	1.997*			1.107
5	(AC-SIZE)	0.014	0.889			1.241
6	(AC-MULT)	-0.009	-1.436			1.227
7	(FIRM SIZ)	0.005	0.870			1.743



8	(LEV)	-0.005	-1.544		1.374
9	(MTB)	-0.004	-0.652		1.210
10	(AUD)	-0.011	-1.554		1.746
11	(PROF)	0.134	2.972**		1.122

\* indicates significance at the (.05) level; \*\* indicates significance at the (.01) level; \*\*\* indicates significance at the (.001) level.

### ▪ Conclusion

This study examines the association between audit committee characteristics as an internal corporate governance mechanism and accounting conservatism in the Egyptian context. Five audit committee attributes are investigated, namely, independence, financial expertise, size, diligence and members' multiple directorships. Two methods are used to measure conservatism (the asymmetric timeliness and the accrual based).

The results of this study show that there is an evidence that firms that follow recommended governance practices adopt more conservative accounting. In some details, regarding the asymmetric timeliness measure of conservatism, the study show that the most conservative companies are companies which have effective audit committee that are more independent, have financial expertise and have a higher frequency of meeting. On the other side, the results are also generally robust when the accrual based measure of

conservatism as suggested by (Givoly & Hayn, 2000) is used, except for financial experts which show a positive but not significant relation with accrual based accounting conservatism.

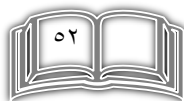
Both the audit committee size and audit committee members multiple directorships didn't show a significant relationship with accounting conservatism through both models. The findings are consistent with prior studies showing that accounting conservatism is related to stronger corporate governance mechanisms (Beekes et al., 2004; Ahmed & Henry, 2012).

Indeed, the results of the association between conservatism and good governance support the complementary effect between them, which support the contention that governance used conservatism as a tool to constraints managers opportunistic behavior to save shareholders rights and ensure the quality of the financial reports. In other words, corporate governance is an explanation or determinant of accounting conservatism besides contracting, litigation, taxation and regulatory explanation. Taken together, it is found that higher level of accounting conservatism can be explained by efficient mechanisms of corporate governance.



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