

RESEARCH ARTICLE

Corporate governance and accounting conservatism in Islamic banks

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Abstract

We examine whether Islamic banks are more likely to be conservative in their financial reporting than conventional banks, as well as how Islamic banks' unique corporate governance system affects accounting conservatism behaviors. Using a large sample of Islamic banks and their matched non-Islamic banks; based on total assets and geographic location, in 15 countries, we find Islamic banks are more likely to deploy accounting conservatism as measured by loss avoidance, abnormal loan loss provisions, and C-score, respectively. Islamic banks are about 95% more likely to be more conservative in accounting practices than their counterparts, depending on different model specifications. In addition, we report several board characteristics, such as size, independence, reputation, tenure, and diversity, are important determinants of accounting conservatism in Islamic banks. This relationship indicates certain board traits lead to greater monitoring roles, consequently reducing unethical behavior and increasing the degree of conservatism in accounting practices.

KEYWORDS

accounting conservatism, ethics, Islamic Bank, Shari'ah

JEL CLASSIFICATION

G15 ; G21; M41

1 | INTRODUCTION

Following the high-profile downfalls of corporate managers due to ethics violations (e.g., Enron, Adelphia, and WorldCom), and the passage of the SOX Act in 2002,¹ researchers are paying more attention to corporate governance.² In particular, regulators, practitioners, and academics have pressed for more sophisticated accounting practices, among which is conservatism. Conservative accounting practices may improve the veracity of financial statements and, therefore, regain public trust and confidence in the financial reporting system. Accounting conservatism is defined as “accounting policies or tendencies that result in the downward bias of accounting net asset value relative to economic net asset value (Ruch & Taylor, 2015).”

Executive managers can implement two types of accounting conservatism: unconditional or conditional (Beaver & Ryan, 2005). Unlike

unconditional conservatism, conditional conservatism depends on economic news events. Conditional conservatism refers to timely recognition of negative news to positive news of economic events in accounting earnings (e.g., goodwill impairment, asymmetry in gain/loss contingencies, long-lived asset impairment, and inventory recorded at the lower of cost or market). Unconditional conservatism occurs through the consistency of recording low book values of net assets relative to their fair values (e.g., immediate expenses R&D, accelerated depreciation methods, allowance for bad debt expenses, and warranty allowance) (Ruch & Taylor, 2015).

Existing literature focuses on commercial banks (hereafter, CBs) and their accounting conservatism. However, this article compares accounting conservatism between Islamic banks (hereafter, IBs) and CBs, and it analyzes IBs' sophistication in accounting practices due to their distinct nature. IBs are interest-free banking and their banking

transactions are based on different financing modes of sharing the basis of payment obligations with revenue accrual, removing the major sources of instability in a free market. Thus far, their distinct nature dictates they will need to follow a strict accounting conservatism (Quttainah, 2012).

To better understand religion's effects on accounting behaviors, we need to analyze environments that could influence accounting decisions. Culture does affect accounting practices (Askary, Pounder, & Yazdifar, 2008). Soll (2014) notes "financial accountability" gets even better when accounting is viewed as part of culture values not just part of a business transaction. Historically, religion has a significant role in shaping and affecting cultural values, such as fairness and honesty (Lewis, 2001). Lewis (2001) argues if culture indeed has such an effect, then religion that influences cultural values does affect accounting practices. Mutch (2016) explores the impact of religion on Scottish accounting texts in the eighteenth century using a sample of five administrative units of the Church of Scotland. He notes accounting practices are broadly shaped by the religious context of the Church of Scotland.

Thus, *Shari'ah* affects the principal-agent relationship based on converting cash into assets that may be worth more or less in the future, which is of prime importance and is the source of profit or loss. Hence, most IBs are rich in cash due to strict adherence to rules regarding what products and services banks offer (Quttainah, 2012). Such strict adherence is also reflected in accounting behavior in accounting behavior (Quttainah, Song, & Wu, 2013). Hence, the intensity of adherence to *Shari'ah*, which is the cornerstone of conducting business and financial deals in IBs, reflects differences in accounting conservatism between IBs and CBs.

As *Shari'ah* is one of the most important determinants of internal governance for IBs, this article asks two questions. First, are IBs more conservative in their accounting reporting compared to CBs? Second, do board characteristics such as size, reputation, tenure, and diversity enhance accounting conservatism practices in IBs?

Following prior studies such as Francis, Hasan, and Wu (2013), Leventis, Dimitropoulos, and Owusu-Ansah (2013), Talebnia and Javanmard (2011), García Lara, García Osmá, and Penalva (2009), and LaFond and Watts (2008), we use three proxies to measure accounting conservatism in the banking industry: loss avoidance, abnormal loan loss provisions (LLPs), and C-score. We control for major bank characteristics, size, growth opportunities, the change in cash flow, and allowance for loan losses, all of which may affect accounting conservatism. Additionally, we control for potential risk differences between IBs and CBs (Quttainah & Almutairi, 2017). CBs and IBs hold different kinds of loans and other asset portfolio structures; thus, they could have different incentives to increase/reduce certain accounting behaviors. We also control for country effects and year effects that are likely to affect accounting conservatism.

Based on a sample of 3,772 bank-year observations from 82 IBs and 82 CBs in 15 countries between 1993 and 2015, we find IBs are more conservative in their accounting practices compared to CBs. In fact, we show IBs are about 95% more likely to be more conservative in accounting practices than their counterparts, depending on

different model specifications. This result holds after adjusting for country and year effects and is robust to the inclusion of various control variables (microlevel and macrolevel). In addition, the average loss avoidance for IBs is 26% compared to 30% for CBs. The abnormal loss loan provision for IBs is 0.1% compared to 0.3% for CBs. Nevertheless, the mean C-score for IBs is 9%, and the mean C-score for CBs is 5%. These results indicate IBs have greater ethical standards, which leads to higher accounting conservatism. They also indicate *Shari'ah* effectively constrains unethical behaviors among IB managers.

We also report several board characteristics such as size, independence, reputation, tenure, and diversity are important determinants of accounting conservatism in IBs. For example, the relationship between loss avoidance and abnormal LLPs (C-score), and board characteristics is negative (positive). This relationship indicates certain board traits lead to greater monitoring roles, consequently reducing unethical behavior and increasing the degree of conservatism in accounting practices.

The remainder of the article is organized as follows. Section 2 reviews the extant literature and develops the research hypotheses. Section 3 describes data collection, sample selection procedures, and empirical models. Empirical main and robustness results are presented in Section 4. Summary and major conclusions are presented in Section 5.

2 | LITERATURE AND HYPOTHESES DEVELOPMENT

2.1 | Features of banks

The banking industry is the most regulated industry in the world, and it is unlike other industries. For instance, its governance structures have numerous unique features that could magnify agency problems. Banks are less visible than nonfinancial firms, which also aggravates agency problems (Caprio Jr. & Levine, 2002) because greater information asymmetry exists among investors.

Adverse selection happens in banks when deposit insurance programs intended to protect small depositors' interests actually lead to moral hazards. These programs may incentivize managers to engage in unethical practices or risky projects. Unlike creditors who have expertise and skills to evaluate bank products and services, and therefore are better at monitoring bank managers, small depositors lack such advantages. In fact, deposit insurance schemes may motivate managers to rely less on borrowing. Thus, managers may be more likely to monitor insured depositors than uninsured creditors, which could expose their banks to litigation risks. Creditors can sue bank directors for mismanagement and misconduct (Petrin, 2012).

In addition, banks are highly leveraged with a significant portion of their debts consisting of cash deposits. On the other side, banks' illiquid assets may fail to meet claims of creditors, creating substantial risks to debt holders (Heremans, 2007). Furthermore, the reputation and credibility of the banking industry are far more critical than in other industries. This is because banks provide a large number of intangible services and run financial operations primarily based on

trust (Stansfield, 2006; Trotta & Cavallaro, 2012). Like other businesses, banks are subject to shocks due to several risks (e.g., credit, bankruptcy, litigation, fraud, and market). However, if one or more banks are exposed to any of these risks, the entire banking industry may be affected, and the financial market at large could be affected as well.³ If this effect becomes contagious, the public trust and confidence in the banking industry may evaporate.

On the other hand, according to the International Association of Islamic Banks (IAIBs), utility in IBs is measured by converting cash into assets. Even though the time value of money is being forfeited, the concept of generating rent on capital is lost, and strict religious guidance prohibits usury (interest) and *gharar* (excessive uncertainty, deception, or risk-taking). For example, interest on credits and cash advances that creates a renter class in society is forbidden (Quttainah, 2012). Despite the highly regulated industry IBs operate in, another important regulatory aspect is the religious internal governance mechanisms that allow banks to call themselves *Shari'ah* compliant.

Features and concepts by which IBs govern their transactions are under the auspices of contracts, which are interest-free. Interest payments are defined as the return on transactions involving the exchange of similar assets (e.g., money for money with time-based premiums or reductions). Note that as unusual as these concepts seem in a traditional context, many of the functional benefits of commercial banking products can be provided in *Shari'ah*-compliant transactions. However, a handful of CBs transactions, such as futures, derivatives, and other transactions that involve risk-taking and gambling are prohibited. Therefore, IBs have many liquid assets, especially cash (Quttainah, 2012).

2.2 | Accounting conservatism

Traditionally, accountants express conservatism by following the rule "anticipate all losses but report no gains." Accounting conservatism requires accountants to verify all transactions carefully before legally reporting any gains, as they are required to recognize all possible losses. In situations where accountants have to choose between two alternatives in financial reporting, accounting conservatism provides rules and guidelines, which keeps them objective and provides fair presentation of the company's financial status.

Prior literature indicates accounting conservatism influences disclosure quality (Ball, Robin, & Wu, 2003; Beekes, Pope, & Young, 2004; Fan & Wong, 2002). Conservatism exists in financial disclosures (Beaver & Ryan, 2000; Givoly & Hayn, 2000) as a result of regulation, taxation, litigation, or contracting (Basu, 1997; Watts, 2003). Boards of directors can adopt accounting conservatism to address agency problems (A. S. Ahmed & Duellman, 2007; Watts, 2003). Accounting conservatism limits managerial opportunism (e.g., reduces excess payments to managers at the expense of shareholders), reduces litigation risk costs, increases the efficiency of debt and other covenants, and maintains surveillance over contracts (Ball & Shivakumar, 2005). Evidence in Francis et al. (2013) also suggests accounting conservatism mitigates information risk and agency problems. Zhang (2008) shows lenders impose lower interest rates on conservative borrowers.

DeFond, Lim, and Zang (2012) report conservative audit clients are less likely to restate accounting numbers. The literature also shows accounting conservatism affects investment efficiency (Chen, Hu, & Lin, 2013; Cho & Choi, 2016; García Lara, García Osmá, & Penalva, 2016).⁴

Conversely, financial market regulators, financial reporting standards-setters, and academics heavily criticize conservatism in accounting practices, arguing it may introduce bias in financial reporting and hence distort financial statements (Gigler, Kanodia, Sapra, & Venugopalan, 2009; Jackson & Liu, 2010 and Watts, 2002). Accounting conservatism tends to understate net assets, and losses, compared to gains, on the income statement are immediately recognized. Therefore, a firm's debt-to-asset ratio (net income) is systematically overstated (understated) compared to its true economic leverage (net income) value. Consequently, the firm's financial position is distorted, thereby reducing its ability to raise capital. In addition, amid the criticism of conservative accounting practices is that accounting conservatism is arbitrary (i.e., managers can have great discretionary power over financial reporting) and has an inconsistent impact on reported income (Chatfield, 1996).

2.3 | IBs and accounting conservatism

Accounting conservatism should be more pronounced in the banking industry compared to other industries because of its high complexity, great information risk, contracting distinctiveness, and intense regulations and rules (Hsu, Novoselov, & Wang, 2017). In Watts (2003), regulators support firms that have conservative accounting and financial practices; doing so helps avoid public criticisms in case these firms go bankrupt. Also, central banks favor banks that establish big LLPs, a sign of accounting conservatism, when economic conditions improve (Turner et al., 2010).

IBs are more likely to exercise conservative accounting policies than CBs for several reasons. First, IBs conduct their business according to the *Shari'ah* law, which stresses social justice and fair distribution of wealth through an Islamic levy known as *zakat*.⁵ Besides corporate taxes, IBs are required to pay *zakat*. This additional obligation strongly incentivizes IBs to be more conservative in their accounting practices compared to CBs (AlAbbad, 2016).

Second, religious people in general tend to be more risk-averse (Miller, 2000) and managers of religious-influenced entities are thus less likely to be sued (McGuire, Omer, & Sharp, 2011). Thus, arguably this may indicate religious people and religious-influenced entities are more likely to be conservative in their decision-making.

Third, agency problems are more pronounced in IBs as opposed to CBs, which motivates IBs to follow more conservative accounting policies. For example, profit-sharing investment accounts represent a major source of funds in IBs.⁶ Holders deposit their funds on a profit-sharing and loss-bearing basis, but they have no power to monitor their funds' performance (Al-Sadah, 2007). Their status provides no rights to monitor management behavior or influence management decisions. In addition, they neither nominate board directors nor hire external auditors. Instead, they rely on shareholders to monitor

management behavior and performance. However, equity holders absorb losses on the asset-backed securities, raising concerns about transparency and disclosure (Mejía, Aljabrin, Awad, Norat, & Song, 2014). Moreover, transparency in corporate governance disclosures still need to be improved significantly (Abdullah, Percy, & Stewart, 2014). Less transparency causes information asymmetry between banks and their shareholders, creating greater concerns over credibility and confidence. All these agency problems put pressure on IBs to be more conservative in their accounting and reporting practices.

Fourth, regulators still have major concerns about whether the features of the Islamic banking system have an impact on the development of this industry. Although several countries have improved their regulatory and supervisory Islamic banking frameworks, more progress is still required (López-Mejía, Aljabrin, Awad, Norat, & Song, 2014; Song & Oosthuizen, 2014).

Fifth, managers with less ethical commitment may exploit the flexibility in accounting standards to inflate reported earnings (Choi & Pae, 2011). IBs' ethical environments, however, promote honesty in financial reporting and discourage unethical business behavior. Strict adherence to *Shari'ah* should thus counter any immoral incentives and reduce inefficiency arising from moral hazards and information asymmetry (Hasan, 2012).⁷ In fact, Quttainah and Almutairi (2017) show IBs engage in fewer unethical accounting practices (measured by accruals and abnormal LLPs) than CBs do. The ethical element potentially incentivizes firms to follow more conservative accounting practices, according to Choi and Pae (2011), who find firms with greater commitments to business ethics report earnings more conservatively.

Last, IBs have an additional layer of corporate governance, *Shari'ah* supervisory boards (SSB), which strictly ensure all IBs' accounting and financial transactions adhere to Islamic principles.⁸ There are different Islamic schools of thought and each school has a different interpretation for the *Shari'ah* and *Sunna* (Quttainah, 2012). Consequently, since members of the SSB come from different Islamic schools of thought, these differences may exacerbate disagreements regarding *Shari'ah*-compliant transactions and interpretations of *Shari'ah* principles. This could largely reflect variations in financial reporting, auditing, and accounting treatments (Mejía et al., 2014), creating more pressure on IBs to adopt prudential accounting practices. The conservative and ethical inclinations of IBs can thus mitigate fraudulent financial reporting and, therefore, may have important accounting and economic implications. The following hypothesis is, therefore, stated in an alternative form:

Hypothesis 1 *Ceteris paribus, IBs have more conservative accounting practices than CBs.*

2.3.1 | Board size and accounting conservatism

Board size affects the level of consensus, shared knowledge, and expertise among directors. In turn, board size is critical to board effectiveness and firm performance improvement, especially when networks and access to economic resources are important (Kiel &

Nicholson, 2003). Some companies require larger boards for effective monitoring (Adams & Mehran, 2003). In complex companies (e.g., banks), for example, the benefits of larger boards outweigh the costs (Coles, Daniel, & Naveen, 2008). Larger boards maintain better networks and have more expertise (Dalton, Daily, Johnson, & Ellstrand, 1999).

Empirical evidence also suggests bankruptcy is less likely in firms with larger boards (Chaganti, Mahajan, & Sharma, 1985). Similarly, evidence shows firms with larger boards are less risky (Birnbbaum, 1984), have less information asymmetry (Chen & Jaggi, 2000), are more visible in their communities (Provan, 1980), enjoy lower cost of debt (Anderson, Mansi, & Reeb, 2004), and are better in allocating resources (Goodstein, Gautam, & Boeker, 1994; Pearce & Zahra, 1992). In Pfeffer and Salancik (2003), firms with larger boards perform better because they budget, raise external capital, and manage leverage more efficiently. Kiel and Nicholson (2003) also show firm performance increases with board size.

Alternatively, a large board can be less effective at monitoring management, because having more directors means more complicated coordination and communication, as well as delays in decision-making processes (Eisenberg, Sundgren, & Wells, 1998; Forbes & Milliken, 1999; Gladstein, 1984; Judge & Zenithal, 1992; Shaw, 1981; Yermack, 1996). Small boards are also more effective than large ones because directors are less likely to disagree (Lange et al., 1978) and more likely to encourage genuine interaction and debate (Firstenberg & Malkiel, 1994).

Studies on the relationship between board size and accounting conservatism are limited. Boussaid, Hamza, and Sougne (2015) and K. Ahmed and Henry (2012) do find a negative association between board size and conditional conservatism. Based on a sample of 3,852 firm-year observations of nonfinancial Malaysian public firms over 2001-2012, Abdul-Manaf, Amran, and Zainol-Abidin (2014) show firms with smaller boards are more conservative. A. S. Ahmed and Duellman (2007), however, show no link between conditional conservatism and board size. Therefore, because prior studies provide mixed evidence on the effect of board size on financial reporting quality and accounting conservatism, we predict a relationship between accounting conservatism and board size but state no direction. Put formally:

Hypothesis 2 *Ceteris paribus, in IBs, accounting conservatism is related to board size.*

2.4 | Board composition and accounting conservatism

Incentives and the ability to monitor and control management vary among directors. In addition, the characteristics of directors affect board efficiency. Empirical evidence indicates boards with independent outside directors are more effective. Weisback (1988) reports CEO turnover following poor financial performance is more likely to occur in firms when the board of directors are dominated by independent directors. Evidence also shows firms with higher proportions of

independent outside directors are less likely to manage earnings (Dechow, Sloan, & Sweeny, 1996) and disclose more negative information (Abrahamson & Park, 1994). Daily and Delton (1994) indicate financially distressed firms with more independent outside directors are more likely to avoid bankruptcy than financially distressed firms with few independent outside directors. In Kiel and Nicholson (2003), firm performance rises when more independent directors are on the board.

Nonetheless, a sample of 1,271 UK listed companies between 1993 and 1996 shows independent outside directors curb income-increasing earnings management but have no effect on income-decreasing manipulations. Klein (2002) documents a negative association between the presence of independent outside directors and discretionary accruals for a sample of 692 U.S. public firms in the S&P 500 index during 1992–1993. In addition, Xie, Davidson, and DaDalt (2003) show earnings management is less likely to occur in firms that have higher proportions of independent directors. That study uses a sample of 290 public firms in the S&P 500 index in 1992, 1994, and 1996. Park and Shin (2004) report similar results using 539 Canadian listed companies for the period 1991–1997.

These findings show independent directors improve monitoring and thus may improve earnings quality. This implies independent outside directors are more conservative about governance, which should lead to greater accounting conservatism. Therefore, in the presence of more independent outside directors, management is less likely to compromise the quality of financial disclosures and more likely to require conservative practices.

Prior studies show a link between board independence and accounting conservatism. For example, based on a sample of 41 UK firms, Beekes et al. (2004) show accounting conservatism increases when the number of independent directors increases. A. S. Ahmed and Duellman (2007) use a sample of 306 firms in the S&P 500 firms over fiscal years 1999–2001 and report a positive relation between the percentage of outside directors and conservatism. Kankaanpaa (2009) examines the relation between board independence and earnings quality, measured by earnings timeliness and earnings conservatism, for a sample of Finnish publicly listed companies. His findings indicate the proportion of independent directors has a positive effect on the timeliness of bad news reflected in earnings. Based on these findings, we offer the following hypothesis:

Hypothesis 3 *Ceteris paribus, in IBs, accounting conservatism is positively related to the proportion of independent outside directors.*

2.5 | Board reputation and accounting conservatism

Independent outside directors have heterogeneous incentives to monitor and control management. However, their oversight roles may vary according to the value of their reputations. Specifically, research shows the market for managerial labor motivates independent outside directors to develop reputations as decision experts by monitoring and controlling management (Fama & Jensen, 1983). Shivdasani

(1993) reports the reputations of independent outside directors, proxied by multiple directorship, increase the effectiveness of board monitoring. In Masulis and Mobbs (2014), directors who serve on more prestigious directorships are less likely to resign when firm performance is poor. They also show a positive relationship between firm performance and the reputations of independent outside directors.

In a different working article, Masulis and Mobbs (2012) show firms with highly reputable directors are less likely to be delisted or sued, violate debt covenants, manage earnings, restate earnings, backdate options, and reduce cash dividend rates. Also, Masulis and Mobbs (2011) and Mobbs (2013) report boards with directors who have directorships in other firms make better decisions and monitor CEO behavior more closely. Furthermore, Kaplan and Reishus (1990) report firms are less likely to cut dividends if their boards consist of directors with multiple directorships.

Prior studies also show director reputation is largely influenced by specific key board decisions. For instance, directors of firms that restate earnings or commit fraud have fewer future directorships (Srinivasan, 2005). In addition, Kaplan and Reishus (1990) show directors in firms that cut dividends are nominated for fewer directorships in the future. Therefore, it is evident that the reputations of independent outside directors decline if they exert weak governance and are sloppy monitors. Accordingly, reputable directors are perceived as more effective monitors. In addition, the personal costs of reputation and career impairment may make independent directors more cautious, encouraging them to adopt conservative accounting practices. This leads to the following hypothesis:

Hypothesis 4 *Ceteris paribus, in IBs, accounting conservatism is positively related to the reputation of independent outside directors.*

2.6 | Board tenure and accounting conservatism

Prior studies examine the association between a director's tenure and his or her ability to monitor management (Beasley, 1996; Berberich & Niu, 2011; Bonini, Deng, Ferrari, & John, 2015; Rutherford & Buchholtz, 2007; Schnake, Fredenberger, & Williams, 2005; Sharma, 2011; Vafeas, 2003). Empirical evidence indicates longer-tenured outside directors are more effective monitors and hence are better able to prevent fraud (Beasley, 1996) and 10-K violations (Schnake et al., 2005). Sharma (2011) shows a positive association between the tenure of independent directors and the likelihood of dividend payouts. Bonini et al. (2015) note longer-tenured independent directors are better monitors due to their ability to gather, maintain, and share valuable information about their firms. Their evidence also shows such firms are more profitable and have higher market values. In turn, independent directors with longer tenures are associated with greater business stability, tend to have more knowledge about the company, maintain more governance experience, and contribute more to boardroom discussions.

On the other hand, longer tenures can adversely affect firm performance. For instance, increased familiarity between directors and

management can jeopardize independence (Fracassi & Tate, 2012) and, therefore, weaken monitoring. Vafeas (2003) shows outside directors with long tenures are less effective monitors. Directors also become less vigilant as they get closer to retirement; directors in their early years of board service tend to be better monitors, as their ability will be assessed and rewarded by an efficient labor market (Huang, 2013). In addition, Huang (2013) reports a negative link between the tenure of outside directors and the quality of financial reporting. He finds newer outside directors make better acquisition decisions, engage in less earnings management, are more likely to replace bad managers (i.e., CEOs), and support more conservative accounting practices. Given the two competing views on how tenure affects monitoring efficiency, we expect a relationship between accounting conservatism and director tenure but with no direction. Therefore, we offer the following hypothesis:

Hypothesis 5 *Ceteris paribus, in IBs, accounting conservatism is related to the tenure of independent directors.*

2.7 | Board diversity and accounting conservatism

A diverse board consists of directors with unique traits (e.g., gender, ethnicity, age, and education) that may affect firm value. For example, board diversity may boost creativity and innovation, produce more effective problem-solving (e.g., Watson, Kumar, & Michaelsen, 1993; Wiersema & Bantel, 1992), enhance access to different resources and global connections, signal the firm's commitment against minority discrimination, cultivate an image of corporate social responsibility (Ferrira, 2010), foster leadership efficiency, and contribute to a better understanding of the marketplace (Robinson & Dechant, 1997).

Furthermore, although the role of the board directors is vital to countering managerial opportunistic behavior (Donaldson & Davis, 1991), boards can be more effective if they are diverse. Agency theory argues board diversity increases board independence, leading to more activism and better monitoring of management (Carter, D'Souza, Simkins, & Simpson, 2010). In particular, evidence shows female directors have a positive effect on firm value (Campbell & Minguez Vera, 2010; Campbell & Minguez-Vera, 2008). In Lückerrath-Rovers (2010), Dutch firms with female directors outperform their counterparts. Evidence also shows the presence of female directors reduces discretionary accruals, which suggests more accounting conservatism (Peni & Vähämaa, 2010; Srinidhi, Ferdinand, & Tsui, 2011).

However, few research articles show a positive link between board gender diversity and accounting conservatism. Boussaid et al. (2015), for instance, show greater gender diversity promotes more conservative accounting practices. In Zhou (2012), firms adopt more conservative accounting practices when they transition from all-male boards to boards with at least one female director.

Other studies also show a positive relationship between other aspects of board diversity and firm performance (e.g., Marimuthu, 2008; Marimuthu & Koladaiamy, 2009a; Nishii, Gotte, & Raver, 2007). Kim and Lim (2010) examine the association between the

diversity of independent outside directors and the value of Korean firms. They find diversity in age and academic majors among independent outside directors has a positive impact on firm valuation. They also show the proportion of outside independent directors with government experience positively influences valuation.

Alternatively, there could be some downsides to board diversity. In Ferrira (2010), for example, demographically dissimilar directors have different values and views, which could reduce interaction and communication among directors. In addition, such directors could have limited interpersonal attraction and fragile board cohesiveness.

Another downside of board diversity could be the possibility of nominating directors for their demographic characteristics rather than for their experience and qualifications. Some prior literature does show board diversity (i.e., gender) has a negative impact on firm value (e.g., Palmberg, Eklund, & Wiberg, 2009). In addition, Sultana and Van der Zaha (2011) report Australian firms with female directors practice less accounting conservatism. Other research, however, shows no association between board diversity (e.g., ethnicity) and firm value (e.g., Marimuthu & Koladaiamy, 2009b; Marimuthu & Koladaiamy, 2009c).

Empirical evidence on how board diversity affects accounting conservatism is inconclusive and scant, which makes it difficult to predict whether an association between board diversity and accounting conservatism exists. However, the aforementioned studies should provide a basis for our empirical tests. This leads to the following hypothesis:

Hypothesis 6 *Ceteris paribus, in IBs, accounting conservatism is not related to board diversity.*

3 | DATA AND METHODOLOGY

3.1 | Data collection procedure

Our sample consists of listed IBs available in the *BankScope* database between 1993 and 2015. We construct a balanced panel sample and eliminate IBs with missing accounting data in the *BankScope* database. In addition, we exclude development and investment IBs from the sampling frame. These procedures result in 100 IBs with full accounting data. Furthermore, we delete 18 IBs that do not have the same accounting years and have incomplete governance scores in the Risk Metrics database. This procedure results in a balanced sample of 82 IBs with full 22-year bank information, yielding 1,886 firm-year observations.

IBs with CBs are matched based on total assets and geographic location. Our matched sample consists of 82 CBs from 15 countries. Data on regular board characteristics, number of directors, IBs and CBs specializations, assets, liabilities, earnings, expenses, credit ratings, country credit ratings, and risk-rating information are manually retrieved from the *BankScope* database and supplement it with information from several country-level and bank-level websites. The outcome of both samples consists of 3,772 observations for 164 banks. Table 1 depicts the frequency distribution of IBs. We find Bahrain has

TABLE 1 Frequency of Islamic banks (IBs) across countries

Country	Freq.	Percentage
Bahrain	828.33	21.96
Bangladesh	125.61	3.33
Egypt	138.06	3.66
Indonesia	35.46	0.94
Iran	276.11	7.32
Jordan	77.33	2.05
Kingdom of Saudi Arabia	138.06	3.66
Kuwait	276.11	7.32
Lebanon	92.04	2.44
Malaysia	322.13	8.54
Pakistan	414.17	10.98
Qatar	173.51	4.60
Sudan	368.15	9.76
Turkey	184.07	4.88
UAE	322.13	8.54
Total	3,772	100.00

the highest frequency (22%) and Indonesia has the lowest frequency (0.94%).

3.2 | Measuring accounting conservatism

Because accounting conservatism is “the differential verifiability required for recognition of profits versus losses”, its extreme form is the traditional conservatism adage: “anticipate no profit, but anticipate losses” (Watts, 2003). This means earnings are recognized when they are realized, and losses are recognized immediately. One of the criticisms of conservatism is that understating earnings in the current period could lead to overstating earnings in the future. Nevertheless, we contend that the more negative the relationship between independent variables and both proxies of accounting conservatism, loss avoidance and abnormal LLPs, the more conservative the bank—with an exception for the C-score model as a dependent variable, where the relationship and the independent variables are positive. This means bank managers' ethically responsible and are acting in the best interest of shareholders (Quttainah et al., 2013). Hence, we deploy three different measures due to the absence of a generally acceptable method of testing the level of conservatism (Givoly & Hayn, 2000).

Two proxies of accounting conservatism, loss avoidance and abnormal LLPs, both stem from earnings management, which involves managing financial reporting or structuring transactions to manipulate financial results. Managers typically manage earnings either to mitigate political costs, manage the debt-to-equity ratio, and/or maximize their own benefits (Talebna & Javanmard, 2011). The association between earnings management and conservatism is opportunistic behavior reflected in financial statements. Hence, accounting conservatism is mirrored in the negative correlation between the two proxies of accounting conservatism and the independent variables (Talebna & Javanmard, 2011).

Managing earnings for loss avoidance is widely done in the banking industry and is related to changes in nonperforming loans (a normal or nondiscretionary component of LLPs for possible future credit losses). Loan loss accounting resonates credit-risk-management conduct and creates information gap between top management and stockholders (Nichols, Wahlen, & Wieland, 2009). Because this measure influences earnings, it requires the utmost degree of caution from management. In addition, this measure involves accrued interest that reflects management's assessments of current LLPs. Consequently, conservatism can be inferred from how managers account for LLPs.

Prior studies show loss-avoidance is an important benchmark for managers (see for example, Burgstahler & Dichev, 1997; Degeorge, Patel, & Zeckhauser, 1999). Consequently, *Loss Avoidance* equals 1 if a bank has a small return on asset (ROA) (income before taxes, scaled by total assets) between 0 and 0.01; *Loss Avoidance* equals 0 otherwise (Kanagaretnam, Krishnan, & Lobo, 2010). When *Loss Avoidance* equals 1, the organization is less conservative in accounting. When it is 0, we assume the organization does not tamper with anticipated losses and immediately acknowledges losses (see the Appendix for variable definitions).

The second measure is the abnormal (discretionary) LLP (*Abnormal LLP*), which measures banks' accounting conservatism. It is a frequent and widely accepted measure of banking conservatism, computed as the absolute value of the residual from the following model:

$$LLP = \beta_0 + \beta_1 \text{Beglla} + \beta_2 \text{ChangeLoan} + \beta_3 \text{NPL} + \beta_4 \text{IndNPL} + \beta_5 \text{Country} + \beta_6 \text{Year} + \varepsilon. \quad (1)$$

The residual from Equation (1) is *Abnormal LLP*. Because earnings management can increase or decrease income, we use the absolute value of LLP. Through regressing the differential persistence of earnings increases and decreases across banks, we estimate the association between LLPs and changes in nonperforming loans, as well as the association between loan loss allowances and total loans. Abnormal LLPs are the earnings component we expect to be managed. Existing empirical research concerning earnings management at banks indicates a positive association between the discretionary part of LLPs and earnings, which suggests banks use abnormal LLPs to manipulate earnings (Beatty, Berger, & Magliolo, 1995). Hence, the discretionary part of abnormal LLPs is negatively related to earnings, which means banks do not use abnormal LLPs to manage earnings. Disintegrating total accruals into discretionary and nondiscretionary parts, conditional accounting conservatism is primarily associated with the discretionary part of accruals, which is managed. Furthermore, prior literature indicates earnings management is absorbed in stock prices because investors anticipate managers to manipulate earnings. Conservatism may reduce managers' incentives to manage earnings.

C-Score, our third measure of accounting conservatism, is developed and implemented by Khan and Watts (2009) based on the Basu model (1997), which measures asymmetric timeliness. The C-score takes into account variations in firm-specific characteristics (size,

M/B, and leverage) and year (Khan & Watts, 2009). The basic model of Basu (1997) is specified as:

$$X_i = \beta_1 + \beta_2 D_i + \beta_3 R_i + \beta_4 D_i R_i + \varepsilon_i, \quad (2)$$

where i indicates the company, X is earnings, R is returns, and D is a binary variable that equals 1 if $R < 0$, and 0 otherwise. Therefore, the coefficients of R_i (β_3) and $D_i R_i$ (β_4) represent the good-news timeliness and the incremental timeliness for bad news over good news (i.e., conservatism), respectively. We calculate β_3 and β_4 as follows:

$$G\text{-score} = \beta_3 = \mu_1 + \mu_2 \text{size}_i + \mu_3 M/B_i + \mu_4 \text{leverage}_i. \quad (3)$$

$$C\text{-score} = \beta_4 = \lambda_1 + \lambda_2 \text{size}_i + \lambda_3 M/B_i + \lambda_4 \text{leverage}_i. \quad (4)$$

where $Size$ is the natural log of the market value, M/B is the market-to-book ratio, and $Leverage$ is the debt-to-equity ratio. Then, we replace β_3 and β_4 , computed in Equations (3) and (4), respectively, into Equation (2). Following Khan and Watts (2009), we also include the three firm characteristics (size, M/B, and leverage) separately in Equation (2) to have better estimates of accounting conservatism. Therefore, we obtain the following regression model:

$$\begin{aligned} X_i = & \beta_1 + \beta_2 D_i + R_i (\mu_1 + \mu_2 \text{size}_i + \mu_3 M/B_i + \mu_4 \text{leverage}_i) \\ & + D_i R_i (\lambda_1 + \lambda_2 \text{size}_i + \lambda_3 M/B_i + \lambda_4 \text{leverage}_i) \\ & + (\delta_1 \text{size}_i + \delta_2 M/B_i + \delta_3 \text{leverage}_i + \delta_4 D_i \text{size}_i + \delta_5 D_i M/B_i \\ & + \delta_6 D_i \text{leverage}_i) + \varepsilon_i. \end{aligned} \quad (5)$$

3.3 | Measuring independent and control variables

Following Quttainah et al. (2013) and Almutairi and Quttainah (2017), we use *Islamic* as a binary variable that equals 1 if the financial institution is an IB, and 0 otherwise. *Board Size* is defined as the total number of directors serving on the board. Moreover, independence of board directors (*Board Independence*) is the average tenure of all outside directors divided by the total tenure for all directors on the board (Huang, 2013). The reputation of independent directors (*Board Reputation*) is a binary variable equal to 1 if an independent director is also on the boards of more than three other firms (Fich & Shivdasani, 2007). The tenures of independent directors (*Board Tenure*) are measured as the year of annual meeting minus the start year of directorship, minus any breaks in directorship service (Huang, 2013). Following Blau index (Blau, 1977), we calculate board diversity age (*Board Diversity Age*) and board diversity gender (*Board Diversity Gender*)⁹ as $1 - \sum_{i=1}^s P_i^2$ where s is the number of categories and p is the fraction of directors belonging to category i .

As for control variables, we include several bank characteristics that could affect earnings management—specifically that both are used as proxies for accounting conservatism in the empirical analysis. We control for growth opportunities (*Growth*), measured as the ratio of M/B equity value from the beginning to the end of year t . Equity

value, determined by the firm's growth opportunities and past asymmetric timeliness earnings, is reflected in the M/B ratio (LaFond & Roychowdhury, 2008; Roychowdhury & Watts, 2007). Lobo, Parthasarathy, and Sivaramakrishnan (2008) indicate banks with growth opportunities show more accounting conservatism in their financial reporting. In contrast, accounting conservatism is less pronounced in high-growth firms, which tend to demonstrate more aggressive reporting behavior (Lobo et al., 2008). Thus, because the link between growth opportunities and accounting conservatism is unclear, we are unable to predict the sign of *Growth*. Bank size (*Bank Size*) is measured as the natural logarithm of total assets at the end of the year. Unlike small firms, large firms have different asymmetric timeliness of earnings (Givoly, Hayn, & Natarajan, 2007) and demonstrate less accounting conservatism as they disclose more information to the public using different methods of information dissemination (LaFond & Watts, 2008). Conversely, large firms encounter lower operational risk and thus adopt more conservative accounting practices (Callen, Segal, & Ole-Kristian, 2010). Therefore, we expect a link between growth opportunities and accounting conservatism but do not predict the sign on *Bank Size*.

We also control for operating cash flow (*Cash Flow Change*) because profitable firms tend to be more conservative in their financial reporting (A. S. Ahmed & Duellman, 2007). We compute the variable as the change in cash flows (income before taxes and LLPs) during year t deflated by beginning total assets. Further, loan loss allowance (*Allowance*) is controlled and calculated as total loan loss allowance at the end of year t scaled by total assets at beginning of year t , respectively. Andreou, Cooper, Louca, and Philip (2017) argue bank managers who apply accounting conservatism to their financial reporting recognize adequate LLPs consistently each period based on their forecasts of the loan loss allowance balance and expected losses. Therefore, we expect a positive link between *Allowance* and accounting conservatism.

In addition, we control for the risk in total assets (*Risk Assets*), calculated as total risk assets scaled by total assets at the beginning of year t , to reflect differences in potential risks among banks (Quttainah & Almutairi, 2017). We expect bank managers who practice accounting conservatism to be less likely to invest in risky assets. Last, we use country and year indicators to control for potential impacts of other country-level factors and year factors in our results.¹⁰

4 | EMPIRICAL RESULTS

4.1 | Descriptive statistics

Table 2 presents the descriptive statistics for the variables used in our tests. The mean *Loss Avoidance* of the IBs and CBs is 26 and 30%, respectively. Also, in the IBs, the mean *Abnormal LLP* and the mean *C-Score* are 0.1 and 0.9%, whereas in the CBs, the average *Abnormal LLP* and the average *C-Score* are 0.3 and 3%. These figures indicate accounting conservatism is more pronounced in IBs.

TABLE 2 Summary statistics of the variables ($n = 3,772$)

Variable	Summary statistics of the variables CBs ($n = 1,886$)					Summary statistics of the variables IBs ($n = 1,886$)				
	Mean	SD	Min	Med	Max	Mean	SD	Min	Med	Max
Accounting conservatism										
Loss Avoidance	0.30	0.48	0.00	0.00	1.00	0.26	0.46	0.00	0.00	1.00
Abnormal LLP	0.003	0.07	0.00	0.00	0.34	0.001	0.05	0.00	0.00	0.34
C-score	0.03	0.95	0.05	0.10	0.79	0.09	0.69	0.07	0.15	0.99
Bank characteristics										
Log assets	12.00	4.75	9.470	7.70	12.05	16.00	5.60	8.40	9.40	14.95
Growth	0.11	0.23	0.00	0.04	0.45	0.18	0.45	0.00	0.06	0.21
Loan ratio	0.57	0.58	0.13	0.22	0.48	0.43	0.34	0.14	0.42	0.62
Cash flow change	0.02	0.03	0.00	0.00	0.02	0.02	0.02	0.00	0.00	0.03
Allowance	0.02	0.00	0.00	0.04	0.02	0.03	0.05	0.00	0.00	0.07
Risk assets	0.68	0.36	0.52	0.61	0.77	0.37	0.25	0.38	0.46	0.56
Beglla	0.02	0.03	0.00	0.00	0.05	0.04	0.05	0.00	0.00	0.01
Change loan	-0.06	0.35	-0.08	0.00	0.00	-0.04	0.30	-0.06	0.00	0.00
NPL	0.05	0.06	0.00	0.00	0.08	0.01	0.04	0.00	0.00	0.04
IndNPL	0.40	0.35	0.00	0.00	1.00	0.20	0.29	0.00	0.00	1.00
Return	5.09	38.49	-19.33	0.66	90.50	4.69	40.42	-15.33	0.26	85.55
Board characteristics										
Board size	10.10	8.22	5.00	10.00	12.00	13.13	9.02	7.00	12.00	15.00
Board independence	0.41	0.42	0.00	0.20	0.82	0.50	0.48	0.00	0.40	0.80
Board reputation	0.10	0.08	0.00	0.09	0.13	0.20	0.16	0.00	0.19	0.22
Board tenure	5.53	2.55	0.00	6.5	12.00	6.75	1.88	0.00	5.25	14.00
Board director age	50.94	56.67	49.00	54.73	68.00	47.48	55.86	35.00	47.00	55.00
Board director gender (female =1)	0.42	0.39	0.00	0.00	1.00	0.55	0.50	0.00	1.00	1.00

TABLE 3 Univariate tests between Islamic banks and commercial banks

	CBs			IBs			Diff.	t value
	N	Mean	SD	N	Mean	SD		
Loss avoidance	1,886	0.30	0.48	1,886	0.26	0.46	0.25***	1.94
Abnormal LLP	1,886	0.003	0.07	1,886	0.001	0.05	0.06***	3.02
C-score	1,886	0.03	0.95	1,886	0.09	0.69	0.062***	2.58
Log assets	1,886	12.00	4.75	1,886	16.00	5.60	0.08***	3.25
Growth	1,886	0.11	0.23	1,886	0.18	0.45	0.029**	1.97
Loan ratio	1,886	0.57	0.58	1,886	0.43	0.34	0.24***	1.33
Cash flow change	1,886	0.02	0.03	1,886	0.02	0.02	0.004	1.22
Allowance	1,886	0.02	0.00	1,886	0.03	0.05	0.032***	2.80

Significance at the 10, 5, and 1% levels is indicated by *, **, and ***, respectively.

In addition, Table 2 shows significant differences between the two subsamples in terms of bank characteristics. For example, IBs, in comparison to CBs, are larger, have higher growth rates, hold fewer loans and larger allowances for loan losses, and invest less in risky assets. The number of IB directors, on average, exceeds the number of CB directors by two. Furthermore, IB boardrooms have higher proportions of independent directors than those of CBs. In addition, independent directors in IBs enjoy longer board tenures and maintain

better reputations than their CB counterparts. Although the average director age in both types of banks falls between 30 and 50 years (Ford, 1992), the average director age is smaller in IBs. Younger directors may enjoy more mental and physical stamina to accept new ideas and learn new behaviors (Koufopoulos, Zoumbos, Argyropoulou, & Motwani, 2008). This should be more pronounced in IBs because Islamic banking is growing in size and appeal, even in non-Muslim countries.

TABLE 4 Pearson correlation matrix for the variables used in the regression analysis

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1 Loss avoidance	1.00													
2 Abnormal LLP	0.15	1.00												
3 C-score	0.09	0.09	1.00											
4 Islamic	-0.05***	-0.07**	0.34***	1.00										
5 Board size	-0.10***	-0.10**	0.09 [†]	-0.14**	1.00									
6 Board independence	-0.08**	-0.09***	0.23***	-0.27**	-0.29**	1.00								
7 Board reputation	-0.12**	-0.11**	0.03**	-0.1100*	-0.10***	-0.13**	1.00							
8 Board tenure	-0.13***	-0.23**	0.10**	-0.25**	-0.45**	-0.39 [†]	-0.50**	1.00						
9 Board diversity age	-0.26***	-0.22***	0.63***	-0.69***	-0.57***	-0.45***	-0.47***	-0.50***	1.00					
10 Board diversity gender	-0.05**	-0.12**	0.11**	-0.25**	-0.06 [†]	-0.04 [†]	-0.20***	-0.21***	-0.09***	1.00				
11 Bank size	0.13***	0.04	0.07	0.09***	0.00	0.02	0.04 [†]	0.72***	0.70***	0.01	1.00			
12 Growth	-0.070*	-0.05 [†]	0.03**	-0.15*	-0.24***	-0.28***	-0.30**	-0.94**	-0.91**	-0.11**	-0.01	1.00		
13 Cash flow change	-0.15**	-0.30**	0.07***	-0.10**	-0.23**	-0.30**	-0.40***	-0.54***	-0.61**	-0.41 [†]	-0.08 [†]	0.04	1.00	
14 Allowance	0.24**	0.14**	0.11**	0.26**	0.40**	0.37**	0.32**	0.64**	0.10 [†]	0.03	0.00	0.31	0.09	1.00
15 Risk assets	0.04	0.05	0.09**	0.05*	0.07**	0.12***	0.46***	0.18***	0.21***	0.18***	0.16***	0.00	0.07 [†]	0.03

Significance at the 10, 5, and 1% levels is indicated by [†] $p = .10$, * $p = .05$, ** $p = .01$; *** $p = .001$, respectively.

TABLE 5 Impact of Islamic banks on accounting conservatism

Variables	(1) Loss avoidance	(2) Abnormal LLP	(3) C-score
Islamic	−0.54*** (−4.50)	−0.36** (−3.33)	0.15*** (2.19)
Bank size	1.69** (7.03)	0.65* (5.80)	0.98** (2.95)
Growth	0.89 (−3.19)	0.54* (3.18)	0.52* (0.35)
Cash flow change	−9.05** (−7.05)	−11.75** (−5.58)	8.00*** (4.98)
Allowance	−7.64* (−7.21)	−0.77 (−3.00)	7.55 (3.40)
Risk assets	0.30 (0.91)	0.77** (5.50)	0.92** (1.91)
Country and year effects	Y	Y	Y
Observations	3,772	3,772	3,772
Adj. R ²	0.36	0.35	0.30

Heteroskedasticity robust *t*-statistics or *z*-statistics are in parentheses. Significance at the 10, 5, and 1% levels is indicated by *, **, and ***, respectively.

IBs boardrooms also tend to have more female directors than CBs have. This may create a better general picture of how women in Islam can hold decision-making positions and contribute positively in society.

Table 3 depicts univariate tests between CBs and IBs. It shows the mean *Loss Avoidance* values of CBs and IBs are 30 and 26%, respectively, with a statistically significant difference at the 1% level. Furthermore, the mean *Abnormal LLP* value is 0.1% for CBs compared to 0.3% for IBs, with mean difference significant at the 1% level. For the third proxy of accounting conservatism, *C-Score*, the mean is 3% for CBs compared to 9% for IBs, with mean difference significant at the 1% level. These preliminary findings indicate IBs have more conservative accounting policies than CBs, which, albeit initially, supports Hypothesis 1.

4.2 | Main results

Next, we generate a pairwise correlation matrix to ensure no significant association exists between the dependent and independent variables. It provides great insights, albeit prior to performing any univariate tests or regression techniques. Pearson correlation coefficients are shown in Table 4. All correlations between *Islamic* and conservatism measures are statistically significant (p -value < .001). These preliminary findings suggest IBs managers practice more accounting conservatism in their financial reporting than their CBs counterparts. In addition, *Board Size*, *Board Independence*, *Board Reputation*, *Board Tenure*, *Board Diversity Age*, and *Board Diversity Gender* are all

statistically related to the conservatism measures. Collectively, these preliminary results also support Hypotheses 2 through 6.

To see whether multicollinearity exists among variables, we follow the procedure in Hair, Black, Babin, Anderson, and Tatham (1998). The analysis calculates variance inflation factor (VIF) values for two models. All VIF values in Table 4 are lower than the threshold value of 10, suggested by Hair et al. (1998).

Table 5 shows the results of OLS cluster robust standard error estimation, assessing and comparing how corporate governance internal mechanisms affect IBs compared to CBs on accounting conservatism by using three different measures. The table presents unstandardized beta coefficients and standard errors (in parentheses) along with the significance levels of the coefficients. Columns 1, 2, and 3 show the results of the effects of internal governance mechanisms on accounting conservatism using three different measures: *Loss Avoidance*, *Abnormal LLP*, and *C-Score*, respectively.

Hypothesis 1 predicts IBs are more conservative in their financial reporting compared to CBs. The coefficient on *Islamic* is negative and statistically significant for *Loss Avoidance* at p -value < .001 and for *Abnormal LLP* at p -value < .05. Under the *C-Score* measure, *Islamic* is positive and statistically significant at p -value < .001. These results show *Islamic* has a positive impact on accounting conservatism regardless of whether the regression is adjusted for country and year effects and is robust to the inclusion of various control variables. Hence, the results reported in columns 1, 2, and 3 suggest a one-unit increase in *Islamic* is associated on average with a 54%, 36%, and 15%, respectively, increase in the likelihood of being more conservative on accounting reporting. This is consistent with AlAbbad (2016) findings that due to higher litigation risks, IBs have more conservative financial statements than CBs do.

Prudent management of an IB's assets and liabilities does not violate the legitimacy of *Shari'ah* so long as IB management is just in dealing with all depositors (K. Hassan & Lewis, 2009). Adhering to Islamic principles requires more conservatism to reduce managers' tendency and ability to manipulate accounting figures. Therefore, on average, a one-unit increase in IBs is associated with 35% increase in accounting conservatism, which consequently increases the quality of financial data disclosure. Hence, Hypothesis 1 is supported. As for the control variables, overall, their coefficients are statistically significant and in line with those reported in prior studies.

Table 6 shows regression results for Hypotheses 2 through 6. We present the regression results separately for each of our three conservatism measures. Hypothesis 2 predicts *Board Size* influences accounting conservatism. Under the first and second models, the sign of *Board Size* is negative and significant at p -value < 10 and 5%, respectively, suggesting increases in IBs board size have an adverse effect on managers' incentives to manipulate the accounting reporting process. These findings in turn indicate IBs board size does influence monitoring management behavior in manipulating revenues. Birnbaum (1984) finds banks with large boards are less risky, and Chen and Jaggi (2000) contend larger boardrooms are associated with less information asymmetry. Additionally, the result is consistent with Pfeffer and Salancik (2003), suggesting large boards are better at budgeting,

TABLE 6 The association between internal governance mechanism and accounting conservatism

Variables	(1) Loss avoidance	(2) Abnormal LLP	(3) C-score
Board size	−0.33* (−1.45)	−0.11** (−4.32)	0.46*** (3.00)
Board independence	−1.49** (−0.83)	−0.18** (−1.63)	9.80*** (9.02)
Board reputation	−0.91** (−1.95)	−0.052* (−1.95)	6.33** (6.40)
Board tenure	−1.50** (−2.39)	−0.53** (−3.85)	0.75*** (8.33)
Board diversity age	−0.85** (−2.10)	−0.99*** (−1.92)	0.85** (0.18)
Board diversity gender	−0.372* (−1.77)	−0.001*** (−3.12)	0.033*** (4.25)
Bank size	1.59*** (5.03)	0.53** (4.48)	0.25** (2.94)
Growth	0.89 (−1.99)	0.16* (2.08)	0.39** (0.53)
Cash flow change	−15.85*** (−4.95)	−14.75*** (−7.48)	8.11** (5.10)
Allowance	−5.44* (−4.11)	−0.97 (−1.64)	6.34 (2.24)
Risk assets	0.305 (0.61)	0.89** (2.05)	0.45** (2.17)
Country and year effects	Y	Y	Y
Observations	1,886	1,886	1,886
R ²	0.46	0.43	0.47

Heteroskedasticity robust t-statistics or z-statistics are in parentheses. Significance at the 10%, 5%, and 1% levels is indicated by *, **, and ***, respectively.

raising external capital, and managing leverage. Accordingly, greater board size positively influences ethical reporting practices.

Under the C-Score model, *Board Size* is positive and statistically significant at p -value < .01, indicating larger boards increase accounting conservatism. This finding is also consistent with Boussaid et al. (2015), suggesting larger boards reduce accounting reporting risks and ensure conservative accounting practices. In sum, there is a relationship between accounting conservatism and board size, supporting Hypothesis 2.

Hypothesis 3 indicates there is a positive relationship between board independence and accounting conservatism. *Board Independence* is negatively and statistically related to *Loss Avoidance* and *Abnormal LLP* at p -value < .05. Our results are consistent with those reported in Peasnell, Pope, and Young (2000) and Quttainah et al. (2013), which show the presence of independent directors has a negative relationship with income-increasing earnings management and loss avoidance activities. Also, our findings are line with those

reported by Quttainah and Almutairi (2017), Klein (2002), and Xie et al. (2003), who show an inverse relationship between earnings management and the presence of independent directors.

As for the C-Score measure, the coefficient on *Board Independence* carries a positive sign (p -value < .01), suggesting IBs with a greater number of independent directors apply more conservative practices in their financial reporting. This result is consistent with Beekes et al. (2004), which shows boards with a higher proportion of independent directors are more likely to recognize bad news in earnings on a timely basis.

In sum, in IBs, independent directors not only curb the temptation to manage earnings, but also incentivize managers to adopt more conservative accounting practices. Therefore, the more independent directors an IB board has, the more conservative the IB becomes in its accounting reporting, supporting Hypothesis 3.

Hypothesis 4 envisages a positive relationship between independent director reputation and ethical reporting in accounting conservatism. Columns 1 and 2 of Table 6 show *Board Reputation* is economically negative and significantly related to *Loss Avoidance* at the 0.05 level, and *Abnormal LLP* at the 0.10 level. For the C-Score measure, as shown in column 3, *Board Reputation* is positive and statistically significant at p -value < .05.

Independent directors bring more resources to the firm as well as they are better monitors over managements' acts (Fama & Jensen, 1983). Multiple directorships can, therefore, lead to an immediate increase in the effectiveness of board monitoring (Shivdasani, 1993). Our findings are in line with those reported in Masulis and Mobbs (2011) and Mobbs (2013). Their results indicate a board member with multiple directorships makes better decisions and monitors executive management, including the CEO, more carefully. In short, our results in Table 6 suggest reputable independent directors in IBs are more likely to enhance and support the adoption of conservative accounting policies. Hence, Hypothesis 4 is supported.

Hypothesis 5 relates to the link between independent director tenure and accounting conservatism. Columns 1 and 2 of the same table show *Board Tenure* is negatively related to *Loss Avoidance* and *Abnormal LLP*, respectively. Both relationships are statistically significant at a p -value < .05. In column 3, *Board Tenure* has a positive and significant association with C-Score at the 0.01 level. This suggests tenured independent directors exert a negative influence on IB executives' self-serving accounting practices. That is, the longer an independent director's tenure is, the more conservative the IB's managers are when it comes to financial reporting. Our findings coincide with those reported by prior studies, which indicate tenured directors are effective monitors and thus better able to detect fraud (Beasley, 1996; Berberich & Niu, 2011; Bonini et al., 2015; Rutherford & Buchholtz, 2007; Schnake et al., 2005; Sharma, 2011; Vafeas, 2003). Additionally, our findings are consistent with Bonini et al. (2015), which finds tenured independent directors are better monitors and have the ability to gather, maintain, and share valuable information about the firm in ways that build stability; they also have more knowledge about the company, have more governance experience, and contribute more to boardroom discussions. Thus, Hypothesis 5 is supported.

Table 6 also shows the results of the impact of board diversity in terms of age and gender on accounting conservatism. Under the first and the second measures of accounting conservatism, the coefficient on *Board Diversity Age* is negative and statistically significant at the 0.05 level and the 0.01 level, respectively. Nonetheless, in the *C-Score* model, *Board Diversity Age* is positive and economically significant at p -value $< .05$. Such findings suggest greater age diversity on the board contributes to more conservative accounting practices in IBs. Wider diversity in board director age may bring different life insights and perspectives, which encourages a culture of discussion and debate, enhances the overall problem-solving capacity in boardrooms, and hence increases directors' monitoring skills to prevent misconduct. It could also serve as a check on management attempts to engage in profitable business opportunities without ethical constraints.

Moreover, Table 6 shows *Board Diversity Gender* is negatively and significantly related to *Loss Avoidance* (p -value $< .10$) and to *Abnormal LLP* (p -value $< .01$). For the *C-Score* model in column 3, *Board Diversity Gender* is positive and statistically significant at p -value $< .01$. This suggests

gender diversity on the board improves monitoring, which in turn is likely to require a higher degree of verification for reporting good news rather than bad news in financial statements. In sum, accounting conservatism in IBs is higher when their boards are highly diversified in age and gender. Thus, Hypothesis 6 in its null form is rejected. As for the control variables, in general, they all seem to carry their expected signs.

4.3 | Robustness tests

We perform further tests to see whether our prior results hold. First, we rerun a precrisis and postcrisis regression to see whether the 2008 global financial crisis affects the association between IBs characteristics and accounting conservatism. Therefore, we follow Beltratti and Stulz (2009), Fahlenbrach and Stulz (2011), and Francis et al. (2013) in dividing the sample into two different subsamples covering two different periods. The first subsample covers the period from 1993 until the end of 2006. The second subsample covers the period from 2007 until 2015. Our results as shown in Table 7 indicate the relationship

TABLE 7 The influence of Shari'ah Compliant Banks' Board characteristics on accounting conservatism; pre-financial crisis and post-financial crisis

Variables	Before financial crisis			During and after financial crisis		
	(1) Loss avoidance	(2) Abnormal LLP	(3) C-score	(1) Loss avoidance	(2) Abnormal LLP	(3) C-score
Board size	-0.05** (-3.62)	-0.23** (-6.13)	0.055** (3.29)	-0.031** (-4.19)	-0.053** (-3.07)	0.14** (6.22)
Board independence	-0.198*** (-4.81)	-0.44** (-2.74)	0.44** (0.33)	-0.049*** (-8.13)	0.29** (-7.45)	0.86** (3.57)
Board reputation	-0.01** (-2.68)	-0.21** (-4.27)	0.49*** (3.26)	-0.16** (-7.10)	-0.31** (-6.52)	0.58** (3.83)
Board tenure	-0.005** (-1.04)	-0.175** (-8.99)	0.215** (5.05)	-0.54* (-5.79)	-0.53* (-7.44)	0.68* (6.80)
Board diversity age	-0.041* (-3.76)	-0.41** (3.81)	0.73** (4.29)	-0.05** (-2.77)	-0.030* (-2.70)	0.040* (5.76)
Board diversity gender	-0.09** (-2.87)	-0.051*** (-7.37)	0.38** (2.22)	0.041* (2.42)	-0.007* (-5.87)	0.056* (5.20)
Bank size	0.05** (4.12)	0.121** (6.25)	0.086** (5.19)	0.0020* (2.25)	0.022* (2.58)	0.060* (2.66)
Growth	-0.18** (-4.81)	-0.29*** (-4.35)	0.54*** (5.14)	-0.005*** (-4.82)	-0.035*** (-4.01)	0.065*** (7.14)
Cash flow change	-0.04** (-3.96)	-0.28** (-13.85)	0.014** (4.10)	-0.050*** (-13.90)	-0.45*** (-15.00)	0.36*** (11.09)
Allowance	0.02 (0.23)	0.071* (6.95)	0.034** (5.09)	0.001*** (4.13)	0.130*** (6.15)	0.150*** (8.70)
Risk assets	0.080** (3.83)	0.03* (2.21)	0.05** (3.37)	0.029** (2.69)	0.330*** (3.40)	0.334** (6.90)
Country and year effects	Y	Y	Y	Y	Y	Y
Observations	1,066	1,066	1,066	656	656	656
Adj. R ²	0.40	0.39	0.35	0.30	0.31	0.32

Heteroskedasticity robust t-statistics in parentheses. Significance at the 10, 5, and 1% levels is indicated by *, **, and ***, respectively.

between board characteristics and accounting conservatism remains the same in the precrisis and postcrisis periods. IB board traits prior to the financial crisis reflect strong ethical standards that stem from *Shari'ah*. The continuous association in the postcrisis period indicates consistent ethical guidance and that board characteristics and traits shape manager behaviors.

Next, we use two additional measures of accounting conservatism. First, we use the basic model of Basu (1997), which defines the state in which future bad news is expected as one in which current stock returns are negative. Despite the widespread use of the Basu model, the validity of its differential timeliness coefficient has been questioned (see, for example, Dietrich et al., 2007; Givoly & Hayn, 2000). Nevertheless, some recent studies (e.g., Ball, Kothari, & Nikolaev, 2011; Ettredge et al., 2012) find the Basu model useful. Second, we follow Francis et al. (2013) in deploying *Coefficient_Basu*, which is based on an organization-specific Basu model. To derive the estimation for each organization, we run the Basu model for each bank from 1993 to 2015.

$$X_{i,t} = \beta_1 i + \beta_2 D_{i,t} + \beta_3 R_{i,t} + \beta_4 t D_{i,t} R_{i,t} + \varepsilon, \quad (6)$$

where i refers to the bank, t refers to the year, X is earnings, R is returns, and D is a dummy variable that equals 1 if R is less than 0, and 0 otherwise. This regression refers to how sensitive earnings is to news. The sensitivity of earnings to good news is captured by β_{3i} , and earnings sensitivity to bad news is captured by $\beta_{3i} + \beta_{4t}$. Hence, the relationship between earnings sensitivity to bad news and earnings sensitivity to good news is indicated by:

$$\text{Coefficient}_{\text{Basu}} = (\beta_{3i} + \beta_{4t}) / \beta_{3i}, \quad (7)$$

where the higher *Coefficient_Basu* is, the more conservative the bank is (Francis et al., 2013).

Table 8 reports the relationship between IB board characteristics and accounting conservatism using the two additional measures of accounting conservatism. Our results in Table 8 are in line with those reported in Table 6.

5 | CONCLUSION

We investigate the relationship between corporate governance and accounting conservatism in Islamic banking. In particular, we examine whether IBs engage in more conservative accounting practices than CBs do. We also investigate whether IB board characteristics influence accounting conservatism. Our study contributes to the extant literature on the link between corporate governance and accounting information. In addition, we contribute to the growing literature in Islamic banking and its impact on the quality of accounting information. We provide evidence that IBs are more conservative than CBs in their financial reporting practices. The internal governance mechanisms of IBs dealing with microregulations and macroregulations extend to building and strengthening the ethical and moral aspects of reporting processes.

TABLE 8 The impact of Islamic Banks' Board characteristics on accounting conservatism using two different accounting conservatism measures

Variables	(1) Basu's	(2) Coefficient_Bassu
Board size	0.43*** (4.94)	0.21*** (7.13)
Board independence	5.30*** (5.92)	0.54** (5.74)
Board reputation	4.44** (4.40)	0.031*** (4.27)
Board tenure	0.55*** (3.33)	0.75*** (7.99)
Board diversity age	0.77** (0.88)	0.061*** (2.81)
Board diversity gender	0.029*** (5.05)	0.051*** (4.37)
Bank size	0.55** (4.94)	0.033 (2.11)
Growth	0.19** (0.33)	0.033 (2.09)
Cash flow change	11.51** (8.81)	0.329 (0.37)
Allowance	4.44 (1.04)	0.073 (5.22)
Risk assets	0.66** (7.77)	0.022 (3.55)
Country and year effects	Y	Y
Observations	1,556	1,556
R ²	0.42	0.39

Heteroscedasticity robust t -statistics in parentheses. Significance at the 10, 5, and 1% levels is indicated by *, **, and ***, respectively.

We document empirical evidence suggesting *Shari'ah*, the internal board structure, and the proportion of nonexecutive directors have positive impact on accounting conservatism and affect a board's ability to monitor senior management. In other words, *Shari'ah* influences the reporting conservatism process and allows Islamic Banks to maintain higher ethical standards. Such higher ethical standards complement a positive relationship between effective internal governance such as reputation, tenure, board diversity, and monitoring of management that appears conservative in accounting tendencies. Whereas accounting manipulation is the outcome of a desire to affect wealth transfers between various stakeholders. According to Quttainah et al. (2013), CBs have several incentives to engage in earnings management, such as reducing political costs, limiting debt-to-equity ratios, and increasing management's compensation and destroying shareholder value.

Our study has several implications for regulators, corporate managers, and board of directors. For regulators, accounting conservatism should be viewed as an additional prudential regulatory tool to mitigate managements' acts and hence improve the quality of financial

reporting. Corporate managers can implement conservative accounting practices to avoid any future financial failures and litigation risks as a result of disclosing distorted financial reports. For board of directors, enhancing certain characteristics of board directors should reduce agency costs and improve overall corporate efficiency.

The key limitation of this study is two-fold. First, because leverage is defined in a more conventional matter; as the debt to equity ratio, it is possible that Islamic Banks are more conservative in comparison to commercial banks because the nature of their assets and the nature of how their loans are financed. Unlike commercial banks, Islamic Banks' transactions are based on equity financing and this fact has less credit risk, which conforms to *Shari'ah*. Second, another possible conservatism is the relative ratings of different banks within the sample. Hence, a possible future research is to examine the effects of leverage and relative ratings of banks on accounting conservatism.

ENDNOTES

¹ The Sarbanes–Oxley Act of 2002 (Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002), also known as the “Public Company Accounting Reform and Investor Protection Act” (in the Senate) and “Corporate and Auditing Accountability, Responsibility, and Transparency Act” (in the House) and more commonly called Sarbanes–Oxley, Sarbox or SOX, is a United States federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms. There are also a number of provisions of the Act that also apply to privately held companies, for example the willful destruction of evidence to impede a Federal investigation (Sarbanes, 2002).

² The Organization for Economic Cooperation and Development (OECD) refers to corporate governance as “the internal means by which corporations are operated and controlled” (OECD, 2004). The Cadbury Report (1992) defines corporate governance as “the system by which companies are directed and controlled.” Recent work on corporate governance comes from the IMF, World Bank, Basel Committee on Banking Supervision, The Joint Forum, and the Sarbanes-Oxley Act of 2002. In the context of Islamic financial institutions (IFIs), corporate governance is “a set of organizational arrangements whereby the actions of the management of IFS are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the [board of directors], *Shari'ah* board and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IFIs to use resources more efficiently; and compliance with Islamic *Shari'ah* rules and principles,” (IFSB, 2006). *Shari'ah* is a legal system consistent with a code of ethics derived from the *Quran* (the Muslim holy book) and *sunna* (the daily practice of the Prophet Mohammad).

³ There are many incidences of this contagious effect, such as Lehman Brothers (U.S.), Kaupthing, Landsbanki and Glitnir (Iceland), Royal Bank of Scotland Group (Scotland), Banco Privado Português (Portugal), etc. (Carretta, Fiordelisi, & Schwizer, 2017; Dodo, 2017; Mayes, 2017).

⁴ García Lara et al. (2016) show firms with conservative accounting policies have a higher probability of raising more capital. Cho and Choi (2016) report that firms with smaller managerial holdings and foreign investor holdings adopt conservative accounting practices that lower overinvestment. In addition, Chen et al. (2013) document firms following conservative accounting policies significantly increase hurdle rates used to value investment projects and promote conservative investment decisions.

⁵ *Zakat* is an annual levy or almsgiving and is one of the five pillars of Islam. It is customarily 2.5% of a Muslim's total wealth above a minimum acceptable standard of living known as *nisab*. *Zakat* is required to purify Muslims spiritually and physically from stinginess and to help the poor in their community. In countries where the state does not require financial institutions and citizens to pay *zakat*, IBs collect and deposit *zakat* in a *zakat* reserve and distribute it to poor and needy Muslims through various local and international charitable agencies (Hasan, 2010).

⁶ Profit-sharing investment accounts are restricted and unrestricted. The restricted accounts are similar to nondiscretionary wealth-management accounts offered by private banks. IBs manage this type of account under an Islamic contractual system known as *murabaha*. Unrestricted investment accounts are similar to discretionary wealth-management accounts offered by private banks. For reporting purposes, IBs report unrestricted profit-sharing accounts on their statements of financial position but treat restricted accounts as off-balance sheet funds (Archer & Abdel Karim, 2009)

⁷ Following several major corporate failures and scandals, numerous scholars suggest the need for integrating ethics into corporate governance (e.g., Arjoon, 2005; Cladwell & Karri, 2005; Drennan, 2004; Sullivan & Shkolnikov, 2007). The literature addresses several models that provide possible solutions to agency problems such as the takeover model, the blockholder model, board models, executive compensation models, multiconstituency models (Becht & Barca, 2001), the Anglo-Saxon model, the Germanic model, the Japanese model, the Latin model, and the Confucian model (Lewis, 1999). They all tend to resolve agency problems, but they fail to integrate ethics as an essential dimension of corporate governance (Hasan, 2012). In Western theories, utilitarianism, relativism, and universalism are the foundations of ethics (Beekun, 1996). Social interaction, human reason, and experiences construct all ethical principles applicable to corporate governance that are extracted from these theories (Hasan, 2012). Unlike Western models, the Islamic model of corporate governance emphasizes ethics endorsed by Islamic law (i.e., *Shari'ah*). Islamic ethics are divine and religious construct, whereas Western ethics are social values and more transitory in nature (Wilson, 2002). The law in Western countries can be altered, because man and the institutions of man are the lawmakers. But for Muslims, *Allah* (God) is the only lawmaker (Perry, 2011). In Islam, the will of *Allah*, revealed to mankind through Prophet Mohammad, is the only valid source of *Shari'ah*. *Shari'ah* dominates all spheres of Muslims' daily lives, including social matters and commercial transactions. Accordingly, Muslim actions must conform to *Shari'ah* principles.

⁸ *Shari'ah* is a legal system consistent with the *Quran* (the holy book of Muslims) and *sunna* (the daily practice of the Prophet Mohammad). It forbids charging interest and investments in gambling, alcohol, and pornography, as well as certain other activities.

⁹ We first measure director age based on directors born during the same period of time, which are 5-year periods starting from 1940, 1945, 1950, 1955, 1960, 1965, and 1970. Then, we use the standard deviation as a proxy for age diversity. Additionally, gender measurements are based on a two-group measure, which is a female and a male.

¹⁰ We use the OLS cluster robust variance, as it is consistent with the fixed-effects estimator. Linear regression models require a linear association between dependent and independent variables (i.e., no serial correlation independence of the errors, constant variance (homoscedasticity) of errors versus time and any explanatory variables, and normal error distribution). In pooled OLS, the estimator must be consistent and unbiased. Thus, the errors in each time period should not be related to the independent variables in the same time period (Wooldridge, 2003). This technique agrees with Stock and Watson (2002), who show that the standard method of calculating heteroscedasticity-robust standard errors for the fixed-effects estimator generates inconsistent variance estimates.

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How to cite this article: Almutairi AR, Quttainah MA. Corporate governance and accounting conservatism in Islamic banks. *Thunderbird Int. Bus. Rev.* 2019;61:745–764. <https://doi.org/10.1002/tie.22063>

APPENDIX A: VARIABLES DEFINITION

Variable	Definition
Accounting conservatism measures	
Loss avoidance	An indicator equal to 1 if a bank has a small ROA (income before taxes scaled by total assets) between 0 and 0.01; <i>Loss Avoidance</i> equals 0 otherwise.
Abnormal LLP	The absolute value of residual from Equation (1).
C-Score	Khan and Watts (2009) measure based on Basu model (1997).
Basu	Basu (1997) measure.
Coefficient_Basu	Francis et al. (2013) measure.
Independent variables	
Islamic	A binary variable that equals 1 if it is an IB, and 0 otherwise.
Board size	The total number of directors serving on the board.
Board independence	The average tenure of all outsider directors divided by the total tenure of all directors sitting on the board.
Board reputation	A binary variable that is equal to 1 if an independent board director sits on the board of more than three other firms.
Board tenure	The year of annual meeting minus the start year of directorship minus any breaks in the service of directorship.
Board diversity (age, gender)	$1 - \sum_{i=1}^s p_i^2$ where s is the number of categories and p is the fraction of directors belonging to category i .
Control variables	
Growth	The ratio of market-to-book value of equity from the beginning to the end of year t .
Bank size	The natural logarithm of total assets at the end of the year.
Leverage	Total liabilities scaled by total equity.
Cash flow change	The change in cash flows (income before taxes and loan loss provisions) during year t deflated by beginning total assets.
Allowance	Total loan loss allowance at the end of year t scaled by total assets at beginning of year t , respectively.
Risky assets	Total risk assets scaled by total assets at the beginning of year t .
LLP	The normal or nondiscretionary component of loan loss provision.
Beglla	Beginning balance of loan loss allowance.
Change loan	Change in total loans outstanding.
NPL	Nonperforming loans.
IndNPL	An indicator variable that equals 1 if the value for NPL is missing, and 0 otherwise.
Country	Indicator variables for country effects.
Year	Indicator variables for year effects.

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