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The Effectiveness of Risk Management Committee and Hedge Accounting Practices in Malaysia

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Abstract

This study examines the effectiveness of Risk Management Committee (RMC) in influencing hedge accounting practices among non-financial companies listed on the Bursa Malaysia. Our regression results reveal that that there is no significant relationship between the application of hedge accounting and the effectiveness of RMCs. However, there are positive and significant relationships between the choice of hedge accounting and each of company size and leverage. The implications of the findings were discussed.
Key Words: Hedge Accounting, Hedging Activities, Risk Management Committee, Corporate Governance, Financial Reporting

1. Introduction

The issue of accounting for derivatives and hedging activities has been a subject of concern for accountants, auditors and academicians. It is claimed that hedge accounting requirements are complex and burdensome for companies [1,2], which may lead eligible companies reluctant to use hedge accounting to report the use of derivatives for hedging activities. There are various studies in developed countries analysing the application of hedge accounting; these studies provide some significant reasons of why companies tend to avoid from applying hedge accounting [1,5,6]. However, there is very little empirical evidence on companies of emerging markets, especially Malaysia. Although a high level of compliance was reported by several studies in Malaysia in relation to the accounting standards for financial instruments [3,7,8,13], none of these studies reported the use of hedge accounting among Malaysian companies. Hence, our study intend to fill this gap by investigating whether Malaysian companies do or do not apply hedge accounting, and examine whether the effectiveness of Risk Management Committee (RMC) influences this accounting policy decision.

2. Hypotheses development

We used resource dependency theory in this study as an underpinning theory to develop the hypotheses. Since the effectiveness of a board committee to a certain extent depends on the committee's characteristics (e.g., independence, a number of meetings and size), we argue that if an RMC possess these elements and fulfil certain board committee characteristics, its function will be more competent, especially in monitoring and reporting the information involving the use of derivatives for hedging activities [6,9,10]. Since hedging strategies involve crucial processes and planning that will reflect changes in profit and accounting policies, the existence of the RMC members who are independent, expert and diligent can ensure relevant and faithful reporting [6,14]. With regard to this fact, it is assumed that there is positive relationship between RMC's effectiveness and the application of hedge accounting. Hence, our hypothesis is stated as follows:

H1: *The application of hedge accounting is positively associated with the effectiveness of RMC.*

3. Methodology

We used secondary data collected from two separate sources, DataStream and annual reports of companies listed on the Bursa Malaysia. Financial data (i.e., ROA, total assets and leverage) were obtained from the Datastream, and data on RMCs was gathered from the annual reports. The sample comprised 500 large non-financial companies listed in 2013 on the Main Market of Bursa Malaysia based on their total assets. However, the original sample was reduced to 166 companies because not all the companies from the original sample used derivatives to hedge their financial risk exposure or did not have a RMC. The 2013 financial year was chosen because it was the third year where accounting standards for financial instruments are mandatory for all Malaysian listed companies. The three year period was considered sufficient for companies to understand and apply hedge accounting. To examine the relationship between the application of hedge accounting and RMC effectiveness, we employed a binary choice logit model (i.e. Logistic regression). The model is represented by the following structural equation:

$$HACC_i = \alpha + \beta_1 REFF i + \beta_2 CSIZE_i + \beta_2 PROF_i + \beta_3 LEV_i + \beta 6 AUDIT_i + \varepsilon_i$$

Where,

HACC	: 1 if company apply hedge accounting, 0 otherwise.
REFF	: RMC effectiveness Index = Company's actual score on RMC characteristics/ company total possible score of RMC characteristics
CSIZE	: Log of total assets
PROF	: Return on assets
LEV	: Debt to total assets ratio
AUDIT	: 1 if audited by Big 4, 0 otherwise
ε	: Error term

4. Results and Discussion

4.1 Descriptive results

Table 1 shows the descriptive statistics of the dependent and independent variables. It can be observed that the majority of the sampled companies are audited by Big 4 auditors (i.e. 69%). With regard to the selection of hedge accounting practices among sampled companies, it was found that only 27 percent of the sampled companies choose to apply hedge accounting to report their use of derivatives for hedging activities. Many of the companies are not forthcoming to fulfil the requirements needed to apply hedge accounting. The argument that the strict requirements of the accounting standards seem to encourage these companies to ignore hedge accounting might bear some truth [4,6,10]. Hence, the usefulness of the hedge activities information seems to not fulfil the needs of expected users (especially investors), although these companies are not violating the accounting standard requirements about reporting the use of derivatives [1]. Panel B of Table 1 exhibits the descriptive statistics of REEF, CSIZE, PROF, and LEV. The mean score of REFF is about 64 percent of the maximum score of 12. This figure suggests that RMCs in Malaysia is quite effective and this is not surprising because the establishment of risk management committee is still voluntary in Malaysia. On average, the total assets (CSIZE) of sampled companies is about RM 14 million with a maximum score of RM 18.41 million. The mean profitability (PROF) is 7 percent and finally, the mean leverage (LEV) is 22 percent.

Table 1: Summary of descriptive results

Panel A: Descriptive statistics on categorical variables (N=166)

Variable	Frequency	No of Companies	Percentage
AUDITOR	Yes	114	69%
	No	52	31%
HACC	Yes	45	27%
	No	121	73%

Panel B: Descriptive Statistics on Continuous variables

Variable	Mean	Median	SD	Min.	Max.
REFF	0.6425	.6700	.15796	.25	1.00
CSIZE	14.2180	14.0671	1.65002	11.32	18.41
PROF	7.3626	6.1500	7.73282	.00	60.24
LEV	22.1522	21.1700	15.27225	.00	58.46

4.2 Regression results

Table 2 exhibits that the model is significant at predicting the adoption of hedge accounting (χ 2 = 43.25, df= 5, N= 166, p< .001). However, in respect to RMC effectiveness (REFF), Table 2 reveals that our hypotheses is not supported. This indicates that the effectiveness of RMCs does not influence the choice of applying hedge accounting. Since the establishment of RMC is voluntary among non-financial companies in Malaysia, one potential reason that could explain this finding is that the establishment of RMC is based on other strategic considerations [8, 12]. A study by [10] claimed that RMCs through the audit committees (i.e. sub-committee) are not related to the level of accounting standard compliance because the committee members will perform both functions. We discovered that highly leveraged companies are more likely to adopt hedge accounting in reporting the use of derivative of hedging activities (i.e. $p < 0.05$). Consistent with some previous derivatives studies [3,7,10] the adoption of hedge accounting among Malaysian companies can be perceived as to reduce earnings volatility. Moreover, we also found that company size (CSIZE) significantly and positively influences the choice to apply hedge accounting at $p < 0.01$. The odds ratios indicate that companies prefer to apply hedge accounting, which improves by 89 percent when they are large. Consistent with prior research on derivatives disclosure [3,7,10,12], this study supports the notion that large companies tend to provide more quality information, as they incur lower costs of accumulating and disseminating detailed information.

Table 2: Logistic Regression- the choice to apply hedge accounting and RMC effectiveness

Model	Predicted sign	B	SE	Wald	Sign	Odds Ratio
Constant		-10.55	2.380	19.679	.000	0.000
REFF	+	.214	.227	.890	.345	1.238
CSIZE	+	.637	.158	16.307	.000**	1.892
PROF	+	.275	.221	1.546	.214	1.316
LEV	+	.620	.241	6.611	.010**	1.860
AUDITOR	+	.579	.523	1.224	.269	1.784

Chi Square : 43.25
Log likelihood : 150.745
Cox & Snell R^2 : 0.229
Nagelkerke R^2 : 0.333

*Note.**CSIZE** = Ln (total assets); **PROF**= return on asset (ROA); **LEV** = total debt outstanding/total assets; **REFF** = Company's actual score on RMC characteristics/ company total possible score of RMC characteristics; **AUDITOR**= 1 if firms are audited by a big 4 auditor, 0 otherwise*

5. Conclusion

This paper examines the influence of RMC effectiveness on hedge accounting practices of Bursa Malaysia Main Market listed companies. Our initial analysis reveals that the choice to use hedge accounting among non-financial Malaysian listed companies is unsatisfactory. The complexity of the accounting standard appears to hamper companies from applying hedge accounting. Our regression results show that RMC effectiveness do not significantly influence the decision to choose hedge accounting. It appears that company size and leverage influence the application of hedge accounting. Although the data used in this study are cross-sectional and may not provide a dynamic result, this finding may provide useful insights to other researchers, regulators and standard setters as the preliminary view regarding the choice to apply hedge accounting in Malaysia. It is worthwhile to note that further studies should consider examining longitudinal data and testing some other factors that may influence the choice of hedge accounting.

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