

## AUDITING CHARACTERISTICS AND ACCOUNTING CONSERVATISM: A SURVEY OF THE INSURANCE INDUSTRY IN NIGERIA

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**ABSTRACT:** *This research paper investigated the relationship between auditing characteristics and accounting conservatism practices of the insurance industry in Nigeria. This research relied heavily on the published annual reports of companies in the sector as a sector. This sourced through the method of contents analyses for twelve insurance companies for the period spanning 2015 to 2019. Accounting conservatism was proxied as: Book-To-Market-Value (BTMV) ratio. While Audit characteristics was measured in terms of amount of auditing fees (FEES) and number of audit committee members with working and professional knowledge of the financial sector (ACEX); and the number of auditors specializing (SPEC) in audit of the financial sector. The collected data was analyzed using OLS multiple regression method in Eviews. From the results of the data analyses, it was revealed that all three measures of auditing characteristics have a positive but non-significant effect on the accounting conservatism practices of firms in the insurance industry. Based on the above, it was concluded that auditing characteristics vis-à-vis - auditors' fees; audit committee members' professional knowledge of the financial sector; and the number of auditors specialization in the finance sector are not important determinants of accounting conservatism practices by insurance companies in Nigeria. The research consequently suggests that the way to improve accounting conservatism in Nigeria is to use the route of regulatory means by making laws mandating improvement in accounting conservatism.*

**Keywords:** *Auditing characteristics, accounting conservatism, insurance industry*

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### INTRODUCTION

It is basic human nature to want to project a positive image of oneself and endeavors. However, such projections in many cases can be quite misleading as it tends to gloss over problems. The principle of accounting conservatism was developed to curb this natural human behaviour in the way business organizations prepare and present financial statement/reports in order not to mislead stakeholders or give room for opportunistic behaviour by managers of the corporation. Accounting conservatism is a valuation based principle that requires profits to be reported when the cash flows are verifiable and not when cash is received (Basu, 1997). In other words, payoffs from positive NPV projects are to be recorded in the future after the recognition of future cashflows. Thus, conservatism requires prompt recognition of losses and also requires gains to be recognized when incomes are verifiable (Ramzan, 2019).

According to Alves (2019), conservatism benefits financial statement users by constraining managerial opportunism, mitigating the agency problems that are associated with

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managerial investment decisions and also enabling efficient debt covenants in spite of the presence of asymmetric information. With fair and more accurate accounting information as a result of ensuring conservatism in financial statements, it is expected that there will be a higher level of investor efficiency as fair and accurate financial position of the firm help investors to make efficient investments (Ramzan, 2019). Watts (2003) also stated that the verifiability requirement in accounting conservatism increases the quality of the overall financial statement and helps to make the financial statement more credible source information for investors' decisions.

The audit role involves providing a breach in the agency problem by mitigating the ability of managers to act in an opportunistic manner that increases his compensation and remuneration packages at the expense of the shareholders and other stakeholders. Considering the role of the auditor in certifying the contents of the corporation's financial statement and ensuring that the financial statement is credible, it follows that the audit role would be particularly interested in ensuring that the organization sticks to the path conservative reporting.

LaFond and Watts (2008) further stated that the credibility and quality of accounting information provided in financial statements is an integral element that influences investors' decisions as regarding specific investments. Consequently, higher audit quality tends to lead to better investment decisions. This is only possible if managers and auditors are conservative in their reportage. Increase in conservatism increases audit quality, which consequently leads to efficient investment outcomes as a result of the fact that accounting conservatism creates an informed capital market that delivers conservative financial statements constituting verifiable financial numbers (Lu & Sapra, 2009; in Ramzan, 2019). From the above, we infer that the duty of delivering a credible, reliable and high quality financial information and statement that ensures a stable and secure future both for the business organization and investors depends on both managers as well as auditors. To this end, this research paper is intended to investigate the relationship between auditing characteristics and accounting conservatism in insurance companies in Nigeria.

### **Statement of Problem**

The agency problem associated with the opportunistic behaviour of managers of business organization implies that left to their own devices, managers are wont to take action that benefits them even to the detriment of the firm's owners. This is adequately illustrated with the details of many corporate failures which were eventually revealed to be long but were continually covered up by managers in order to continue enjoying the perks that comes with declaring excellent results. Many of such cases have left discerning observers wondering how such activities were able to go unnoticed by the auditors of these organizations. Thus, even though technicalities in the auditors' roles have continued to shield the auditor from sharing in the responsibility of the failures of corporations they were supposed to be over-sighting, it is quite clear that the failure of many business organizations were not just a failure of management but also a failure in the audit role.

One of the areas of failure in the audit role is in ensuring that managers' report accurate and failure results within the principle of accounting conservatism. Thus, managers of these failed organizations are able to report income far above and losses below what would have been possible if the principle of conservatism was adequately adhered to. We embark on this

research in order to investigate the relationship between audit characteristics and accounting conservatism in the insurance industry in Nigeria. While a few research studies of this nature have been conducted in Nigeria, none of the previous research was focused on the insurance industry.

For example, Ayorinde and Babajide (2015) investigated audit tenure and rotation and accounting conservatism in Nigeria, however, their focus was not industry-specific. In the same vein, Oyedokun and Salisu (2018) accounting conservatism and corporate governance while the research of Ugwunta, Ugwuanyi and Ngwa (2018) dealt with audit quality and stock market pricing and reaction. From the above, the present will provide more into the accounting conservatism practices of insurance companies in Nigeria.

### **Objective of Study**

The purpose of this research is to investigate the relationship between auditing characteristics and accounting conservatism in the insurance industry in Nigeria. More specifically, the research will aim to:

Determine the nature of the relationship between auditing fees and accounting conservatism in the insurance industry.

Determine the nature of the relationship between committee members professional experience and accounting conservatism in the insurance industry.

Determine the nature of the relationship between auditors' specialist experience and accounting conservatism in the insurance industry.

### **Study Hypotheses**

Ho<sub>1</sub>: There is no significant relationship between auditing fees and accounting conservatism in the insurance industry

Ho<sub>2</sub>: There is no significant relationship between committee members' professional experience and accounting conservatism in the insurance industry

Ho<sub>3</sub>: There is no significant relationship between auditors' specialist experience and accounting conservatism in the insurance industry.

### **Empirical Review**

According to Ramzan (2019), timely loss recognition or conservatism is an essential element that defines the quality of financial statements, where auditors have incentives to investigate this subjective term. Several motivations have created the need for existence and pervasiveness of conservatism. Contractual obligation, shareholder litigation, taxation, and accounting regulation are the motivations for the existence and pervasiveness of conservatism. Moreover, lower corporate governance quality asks for conservative reporting due to accounting scandals that have occurred in the past and have eroded the investor confidence in the financial markets. Because of conservatism, investors gain more confidence about their investments as earnings are less manipulated in conservative financial reports.

Ayorinde and Babajide (2015) examined the link between audit tenure, rotation, and accounting conservatism using empirical data from Nigeria. Secondary data were randomly gathered by drawing 100 observations from the published financial statements of sample companies operating in the financial and non-financial sectors. Quantitative methods such as

descriptive statistics, correlation, and multiple- regression analysis were used for data analyses. Findings were that; the tenure of auditor has a significant positive influence on firms accounting conservatism; the rotation of audit firms also significantly influences accounting conservatism. The study recommended the mandatory rotation of audit firms' lead engagement partner and the review partner on an engagement for publicly listed companies, and the strict prohibition of providing non-audit services by auditors to their clients to enhance auditors' independence and the quality of audit services.

Ugwunta, Ugwuanyi, and Ngwa (2018) examined the effect of audit quality on share price of Nigerian oil and gas firms using the regression and covariance analyses. Findings suggested that the composition of the audit committee and auditor type had significant effect on the market prices of quoted firms. Findings further revealed that while auditor type (BIG4/NONBIG4), auditor independence, and composition of the audit committee had a positive and significant relationship with market price of shares, tenure of external auditors had a negative relationship with the market price of shares. The implication of the findings was that audit quality will enhance reported earnings and hence the share market prices. The study recommends that firms should strive to associate with the BIG4 external auditors in Nigeria as such an association could enhance the credibility of the audit process and by extension their share prices.

Allam, Gagan, Bahaa and Maher (2012) analyzed the impact of auditing quality characteristics (auditing firm size, contacts with global auditing firms, client retention period, auditing fees and the specialty in client's industry) on the enhancement of the level of accounting conservatism. The study found significant results indicating a low level of accounting conservatism in the financial statements issued by the Jordanian industrial corporations. The results further indicated that some of the characteristics of auditing quality are good, and some of audit quality characteristics had an impact on improving the level of accounting conservatism.

Iliemena and Okolocha (2019) examined the effect of audit quality on financial performance of industrial goods companies in Nigeria. The researchers utilized audit firm rotation and audit fees as proxies for audit quality while financial performance was measured using return on asset. The results showed that audit firm rotation and audit fees both have significant positive effect on return on asset. On this premise, it was concluded that Audit quality has significant positive effect on financial performance. It is therefore recommended that corporate organizations should endeavour to rotate audit firms periodically so as to benefit from their varied experiences and expertise in improving their accounting methods and policies, thus, improve their financial performances, while shareholders should emphasize on audit quality in appointment of auditors with less attention paid to cost considerations.

Ramzan (2019) highlighted the association between accounting conservatism and audit quality of financial statements by regressing the book to market ratio, a measure used for conservatism, and audit fees, a measure used for audit quality, for 84 largest publicly and privately held companies in the United States for the years 2014 - 2017. Findings of the research proved that there is a positive association between accounting conservatism and audit quality. Additionally, the results also concluded that there are added determinants that have an impact on audit quality other than accounting conservatism. Hence, the results sufficiently prove the arguments made by secondary research as well which states that higher conservatism leads to higher audit quality.

Nishtiman, Ku and Noor (2019) examined the impact of audit quality on accounting conservatism in Turkey. Using three different measures of accounting conservatism, they reported that audit quality, in terms of brand name auditor and industry specialist auditor, is positively related to conservatism. The results hold after controlling for operating cash flow, leverage, firm age and sales growth. Overall, the evidence is consistent that accounting conservatism complements firms in the Turkish business environment that engage with high quality auditors to mitigate agency costs.

Saeed and Saeed (2018) investigated the moderating role of audit quality and disclosure quality on the association between corporate governance and accounting conservatism in three emerging economies of South Asia from 2009 to 2015. They found that the level of accounting conservatism is positively associated with corporate governance stature, and higher audit quality and disclosure quality weakens this association. The results suggested that users of financial statements should consider audit quality and disclosure quality for the evaluation of firms especially in environments where corporate governance is complex, ownership is concentrated and markets are still developing.

Allam, Talal, and Emad (2012) investigated the impact of audit committee characteristics (audit committee size, independence, activity, financial expertise, and percentage of common stocks owned by audit committee) on improving accounting conservatism for a sample of 50 Jordanian industrial corporations listed in Amman Stock Exchange (ASE) during the period of 2004-2009. To achieve this goal, accounting conservatism was measured using two methods, Book-to-Market approach and ratio of total accruals to gross profit. By using Pooled Data Regression, the study found that the examined audit committee characteristics are not significantly related to accounting conservatism excluding the financial experience of audit committee members which has a positive relationship with conservatism.

## **METHODOLOGY**

The survey research design was adopted for this research paper. Consequently, the researcher conducted a contents analysis of the annual report of listed insurance companies in Nigeria. All insurance companies with complete information available on their website were included in the sample, Thus, the sample consisted of twelve (12) insurance companies. These included: Axamansard Insurance; Consolidated Hallmark Insurance; Continental Reinsurance; International Energy Insurance; Lasaco Assurance; Law Union and Rock; Niger Insurance; Prestige Assurance; Regency Alliance Insurance; Sovereign Trust Insurance; Standard Alliance Insurance; Wapic Insurance. The period covered was five (5) years from 2015 to 2019. For the purpose of the study, conservatism was measured using Book-To-Market-Value (BTMV) ratio.

While Audit characteristics was measured in terms of amount of auditing fees (FEES) and number of audit committee members with working and professional knowledge of the financial sector (ACEX); and the number of auditors specializing (SPEC) in audit of the financial sector. The Ordinary Least Square (OLS) regression method was adopted for data analyses using E-views. It is proposed that the level of accounting conservatism practiced in each insurance company is dependent on auditing characteristics inherent in the company. This is stated functionally as:

$$\text{Accounting Conservatism} = f(\text{Auditing Characteristics}) \dots \dots \dots (1)$$

Where Accounting Conservatism is measured as Book-To-Market-Value (BTMV) ratio and Auditing Characteristics is measured as amount of auditing fees (FEES); number of audit committee members with working and professional knowledge of the financial sector (ACEX); and the number of auditors specializing (SPEC) in audit of the financial sector, equation 1 above is rewritten as:

$$\text{BTMV} = f(\text{FEES, ACEX, SPEC}) \dots \dots \dots (2)$$

Statistically, this is written as:

$$\text{BMTV} = a_0 + b_1\text{FEES} + b_2\text{ACEX} + b_3\text{ACEX} + \mu \dots \dots (3)$$

The a priori expectation is that  $b_1, b_2$  and  $b_3 > 0$

**Research Data, Results and Interpretation**

Data for the study was sourced from secondary sources through contents analyses of the annual reports of the insurance companies included in the research. Below - in table 1 - is shown the multiple regression result generated from analysis of data using Eviews.

Table 1:

Dependent Variable: BTMV  
 Method: Panel Least Squares  
 Date: 02/05/21 Time: 14:42  
 Sample: 2015 2019  
 Periods included: 5  
 Cross-sections included: 12  
 Total panel (balanced) observations: 60

| Variable           | Coefficient | Std. Error            | t-Statistic | Prob.  |
|--------------------|-------------|-----------------------|-------------|--------|
| C                  | 0.620471    | 0.219559              | 2.825987    | 0.0065 |
| FEES               | 0.000159    | 0.002192              | 0.072738    | 0.9423 |
| ACEX               | 0.036320    | 0.062217              | 0.583763    | 0.5617 |
| SPEC               | 0.063480    | 0.092559              | 0.685828    | 0.4957 |
| R-squared          | 0.094339    | Mean dependent var    | 0.705750    |        |
| Adjusted R-squared | 0.038465    | S.D. dependent var    | 0.272231    |        |
| S.E. of regression | 0.277417    | Akaike info criterion | 0.337752    |        |
| Sum squared resid  | 4.309778    | Schwarz criterion     | 0.477375    |        |
| Log likelihood     | -6.132568   | Hannan-Quinn criter.  | 0.392366    |        |
| F-statistic        | 0.271547    | Durbin-Watson stat    | 1.465247    |        |
| Prob(F-statistic)  | 0.845653    |                       |             |        |

The result in table one above indicates that there is a positive relationship between book to market value (BTMV) as a measure of level conservatism in insurance companies in Nigeria and the fees paid to external auditors. From the coefficient of regression value of 0.000159 implying a unit increase in fees will lead to a 0.000159 units increase in conservatism. Due to the considerably small effect size, we find a non-significant relationship between the variables. This can be verified from the probability of t-statistic value of 0.9423 which is much higher than the 0.05 acceptable limits for rejection of the null hypothesis.

Same scenario is also repeated in the case of the relationship between book to market value (BTMV) and the number of members of the audit committee who have experience and good knowledge of the accounting/finance industry in Nigeria. The results indicates that

increase in the number of experienced audit committee members is predicted to lead to increase in the level of accounting conservatism practiced by the insurance industry in Nigeria. This is evident in the value of the coefficient of value for the variables of 0.036320 which implies that a unit increase in number of experienced audit committee members will lead to increase in accounting conservatism in the industry. We also find that the minimal size effect points to a non-significant relationship which is evident from the probability of t-statistic value of 0.5617 which is much higher than the acceptable limit of 0.05.

Finally, the result indicates that there is a positive relationship between accounting conservatism and the sector specialization of the auditors in the insurance industry. Thus, a higher number of auditors who specialize in the financial sector is predicted to lead to increase in accounting conservatism practices of insurance companies using their services. This is evident from the coefficient of regression value of 0.06348. However, the result is also not statistically significant considering the probability of t-statistic value of 0.4957.

In all, we conclude that auditors' fees (FEES), experience and knowledge internal auditors (ACEX) and auditors specialization (SPEC) in the insurance industry have positive albeit minimal effect on the accounting conservatism practiced by the insurance industry in Nigeria and as indicated by the coefficient of determination results, only about 3.84% of the variation in conservatism can be explain by the changes in auditors' fees (FEES), experience and knowledge internal auditors (ACEX) and auditors specialization (SPEC).

#### **DISCUSSION OF FINDINGS CONCLUSION AND RECOMMENDATIONS**

This research paper investigated the relationship between auditing characteristics and accounting conservatism practices of the insurance industry in Nigeria. This research relied heavily on the published annual reports of companies in the sector as a sector. This sourced through the method of contents analyses for twelve insurance companies for the period spanning 2015 to 2019. Accounting conservatism was proxied as: Book-To-Market-Value (BTMV) ratio. While Audit characteristics was measured in terms of amount of auditing fees (FEES) and number of audit committee members with working and professional knowledge of the financial sector (ACEX); and the number of auditors specializing (SPEC) in audit of the financial sector. The collected data was analyzed using OLS multiple regression method in E-views.

From the results of the data analyses, it was revealed that all three measures of auditing characteristics vis-a-vis - auditors' fees (FEES) audit committee members' professional knowledge of the financial sector (ACEX); and the number of auditors specialization (SPEC) in the finance sector - have a positive but non-significant effect on the accounting conservatism decisions and practices of firms in the insurance industry. Thus, even though we can state that audit characteristics do affect accounting conservatism in the industry, however, such effect cannot be relied on account for conservatism in the industry. Evidence from extant literature point to other sources of conservatism practices of corporate organizations.

These include: government regulations; accounting standards; the stance of the major shareholders on the issue ownership structure and the position of board of directors (Alves, 2019; Soliman, 2014; Saeed & Saeed, 2018; Allam et. al, 2012). Ramzan (2019) additionally,

concluded that there are added determinants that have an impact on audit quality other than accounting conservatism. Hence, the results sufficiently prove the arguments made by secondary research as well which states that higher conservatism leads to higher audit quality.

In a similar study conducted by Allam, Talal, and Emad (2012), they found that audit characteristics are not significantly related to accounting conservatism excluding the financial experience of audit committee members which has a positive relationship with conservatism. Saeed and Saeed (2018) found that the level of accounting conservatism is positively associated with corporate governance stature, and higher audit quality and disclosure quality weakens this association. However, Ayorinde and Babajide (2015) examine the link between audit tenure, rotation, and accounting conservatism and found that the tenure of auditor and the rotation of audit firms significantly influences accounting conservatism.

Based on the above, it was concluded that auditing characteristics vis-a-vis - auditors' fees; audit committee members' professional knowledge of the financial sector; and the number of auditors specialization (SPEC) in the finance sector are not important determinants of accounting conservatism practices by insurance companies in Nigeria. The research consequently suggests that the way to improve accounting conservatism in Nigeria is to use the route of regulatory means by making laws to that effect. Shareholders should be encouraged to demand improved accounting conservatism from insurance companies in order to protect their interests in these organizations. This can be achieved by educating shareholders on the merits on the importance of conservatism in accounting practices by insurance companies.

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