
Accounting conservatism and firm structure: evidence from manufacturing firms in Nigeria

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ABSTRACT

The study looked at the relationship between accounting conservatism and the firm structure of manufacturing firms in Nigeria. The study employed ex post facto research design with a sample of thirty-two (32) publicly traded manufacturing companies in Nigeria. Firm structure was proxied by the asset tangibility ratio and earnings to asset ratio while, accounting conservatism was proxied by earnings accrual. Data were obtained from the annual financial statements of the firms under study for eleven years (2012 through 2022). The panel regression analysis test found that asset tangibility ratio and earnings to asset ratio had no significant relationship with earnings accrual. The study suggests that manufacturing firms should adopt the accounting conservatism principle as this would help to lower managerial opportunism and reduce the risk in accounting reporting that arises from events like contracts and the implementation of poor decisions.

Keywords: Asset tangibility ratio, earnings to asset ratio, earnings accrual

1. INTRODUCTION

Accounting conservatism avows that business accounts have to be prepared with utmost care and a high degree of verification. All potential losses are reported as soon as they are discovered, whereas gains can only be officially recorded once they have been fully realized. Companies can only declare a profit when it has been fully realized and verified. Supporting the conservative approach, when preparing financial projections in accordance with these guidelines, an organization should

consider the worst-case scenario. Accordingly, and in the event that two figures are presented, the accountant should select the one with the lower numbers in order to be cautious. While, uncertain liabilities must be recorded as soon as they are discovered, revenues can only be recorded upon receipt.

Accordingly, accounting conservatism can be viewed as a strategy employed by businesses to lower the risk associated with accounting reporting. The effect of accounting conservatism on firm structure is still debatable, even though it is one of the most enduring characteristics of corporate financial reporting (Basu 1997; Watts 2003). According to some studies, conservatism increases firm value and by extension the structure of the firm by limiting managers' opportunistic behavior (Watts 2003; LaFond and Watts 2008; Francis and Martin 2010; Kim et al. 2011). However, critics of conservatism contend that it may destroy firm value and the structure of the firm and skew information and resource allocation (Gigler et al. 2009; FASB 2010). Therefore, the goal of our research is to investigate how accounting conservatism affects firm structure, particularly as it relates to the tangibility of assets and the earnings to asset ratio of manufacturing companies listed on the Nigerian Stock Exchange. We expect a positive relationship between accounting conservatism and the firm structure of manufacturing firms in Nigeria. Hence, we premise a positive relationship between accounting conservatism and firm structure of manufacturing firms in Nigeria.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Accounting Conservatism

Accounting conservatism principle states that when faced with uncertainty, accountants should proceed cautiously and choose strategies that result in lower reported income and assets. The foundation of conservatism is the belief that, in order to lower the possibility of false financial statements, it is preferable to understate rather than overstate assets and income. In the context of accounting conservatism, gains and revenues are recognized only upon realization or certainty, while uncertainties and potential losses are recognized and accounted for as soon as they are reasonably estimated. With this method, financial statements are guaranteed to present a more cautious and accurate picture of the state and performance of a company's finances. Conservatism primary goal is to keep financial statements from exaggerating a company financial status. By promoting a more cautious approach to accounting, it lowers the risk of financial misstatements, manipulation, and fraud, giving creditors, investors, and other stakeholders a more trustworthy foundation on which to make decisions.

Firm Structure

Numerous accounting ratios, including the equity-to-asset, asset tangibility, non-current asset, intangible asset, inventory asset, and receivable asset ratios, have been used to assess a company asset structure. In order to approximate the firm structure, our study will employ asset tangibility and equity to asset ratio; this firm structure proxy is comparable to those employed in the research by Asiriuwa et al. (2019), Mohammadi et al. (2013), Odia and Osazevbaru (2018).

The term "firm structure" refers to how a company finances its operations and growth through a mix of debt and equity. It demonstrates how a business combines different funding sources, such as bonds, loans, preferred stock, common stock, and other forms of funding, to finance its operations. Firm structure decisions can significantly affect company cost of capital, risk profile, financial stability, and shareholder value.

Asset tangibility ratio

The ratio of non-current assets to total assets in an organization is known as the asset tangibility ratio. The ratio of net tangible assets to book value of all assets is one of the metrics used to express the degree of tangibility of an asset. An alternative way to compute the tangibility measure is as the fixed assets to total assets. The proportion of tangible assets to total assets is shown by this ratio. An entity has more tangible assets (or fixed assets) as a percentage of its total assets, the higher the ratio, and vice versa. A ratio comparing tangible net worth to total tangible assets may also be referred to as the tangibility ratio. This indicates how much an organization depends on tangible assets like inventory items, buildings, manufacturing equipment or machinery, and office furniture (usually PPE) and how much of those assets are financed by owners' equity.

Equity to asset ratio

The equity to asset ratio illustrates the relationship between the amount of money held by shareholders and the firm's total tangible assets, serving as a gauge for the degree of leverage used by the business. One can compute the Equity to Asset Ratio by dividing the total equity of a company by the total assets. The outcome is a percentage that shows how much of the assets of the business are financed by equity. Since the company is less dependent on borrowed funds, a higher ratio denotes a lower level of financial risk. This ratio can be very significant for small businesses. It can [influence the willingness of lenders](#) to provide funding, the terms of any loans, and the perception of the business by potential investors. It can also provide valuable

insights into the financial health of the business, helping to identify potential issues before they become critical.

Accruals

When a business records revenues that it has earned but has not yet been paid for, as well as expenses that it has incurred but has not yet paid, this is referred to as accruals. This is not the same as cash accounting, which records income and expenses as soon as money is received and disbursed. Accruals are useful in clearing up any confusion in accounting when it comes to revenues and liabilities. As a result, companies are frequently better able to predict revenues while monitoring future liabilities.

Earnings Management Theory

The history of earnings management dates back to the 20th century, when Hepworth (1953) defined one of its forms, income smoothing, earnings management, or account smoothening. According to Hepworth, managers use income smoothing to improve their relationships with investors, creditors, and employees as well as to receive tax benefits. Earnings management theory and accounting conservatism are two distinct concepts within the field of accounting. Scott (2003) and Mckee (2005) according to them earnings management theory focuses on the manipulation of financial statements to achieve desired financial outcomes, while accounting conservatism emphasizes the cautious approach to recognizing and reporting financial information. Managers may engage in earnings management to meet analyst expectations, influence stock prices, or obtain desired bonuses or incentives. Earnings management can involve various techniques such as revenue recognition timing, expense manipulation, and income smoothing.

Accounting conservatism, on the other hand, focuses on the cautious approach to financial reporting. It suggests that accountants should err on the side of caution when recognizing and reporting uncertain or future-oriented events. This approach aims to provide more reliable and transparent financial information by recognizing losses and liabilities more quickly than gains and assets. While earnings management and accounting conservatism seem to be contrasting concepts, there can be some overlaps. Managers who engaged in earnings management may use conservative accounting methods to manipulate financial statements. For instance, they may recognize losses quickly but delay recognizing gains to create a conservative appearance while still achieving their desired outcomes. However, it is important to note that accounting conservatism is a principle intended to enhance the reliability of financial reporting, whereas earnings management is typically seen as an unethical

practice. The strict application of accounting conservatism relaxes the adverse effect of earnings management thereby serving as an absorber.

Review of Empirical Literature

El-fattah et al. (2023) carried out an empirical study to look at how Egyptian firms' characteristics were affected by accounting conservatism. The study made use of secondary data collected from Egyptian companies that were listed on the Egyptian stock exchange. Accounting conservatism was measured as an independent variable using the market-to-book ratio, asymmetric timeliness (AT), and asymmetric accrual to cash flow (AACF), and the dependent variables were firm characteristics such as growth, liquidity, leverage, and investment efficiency. Regression analysis was performed on the panel data using the Generalized Least Squares (GLS) method. The results showed that a support relationship between accounting conservatism and firm leverage, as well as a partially support relationship between accounting conservatism and liquidity. However, neither the relationship between accounting conservatism and firm growth nor the relationship between accounting conservatism and investment efficiency was supported by the results.

Ogiriki et al. (2022) investigated the relationship between capital structure and accounting conservatism in Nigeria. The study included a sample of thirty-eight (38) publicly traded manufacturing companies and used an ex post facto research design. Data on asset tangibility and equity-to-asset ratios as well as accounting conservatism (earnings accrual) were gathered between 2012 and 2022. Regression analysis using fixed effects (FE) and random effects (RE) was used statistically. They found that accounting conservatism has a positive and significant impact on firm structure, and that this impact is caused by debt issuance. Additionally, the findings show that asset tangibility and equity-to-asset have higher beta coefficients. Studies examining the relationship between accounting conservatism and cross-listing decisions made by companies were conducted by Mouna (2022). Using a sample of 60 French companies for the years 2014 to 2019, the study found evidence of a reverse causal relationship between accounting conservatism and cross-listing decisions in the US, leading to cross-listed companies in the US having more conservative financial reports. In other words, because US cross-listed companies can afford higher cross-listing expenses and comply with stricter disclosure and governance requirements, more conservative firms are more likely to cross-list in the US and benefit from a higher valuation.

Jorge (2022) looked into the connection between the rate of adjustments to Brazil's capital structure and conditional conservatism. The sample consisted of publicly

traded Brazilian companies that released financial statements between 2009 and 2018. Using the speed of adjustment (SOA) model, the relationship between conditional conservatism and capital structure modifications was investigated. The results found a negative correlation between conditional conservatism and SOA. Additionally, the study separated its sample of over- and under-leveraged companies, with the latter finding a negative correlation. Krismiaji and Ratna (2021) empirically evaluated the connection between conditional conservatism, also known as ex-post conservatism, and the cost of equity capital in Indonesian manufacturing firms using data spanning from 2015 to 2019. Accrual methods were used to measure conservatism, while a price/earnings growth (PEG) model was used to calculate equity capital costs. Utilizing data from 142 companies selected by purposive sampling methods, the study discovered that ex-post accounting conservatism decreased the company's equity capital expenses.

Krema (2021) looked into how cash holding was affected by accounting conservatism and the cost of debts. Data were obtained from the 44 non-financial companies from the Egyptian stock market for the period 2018 to 2020. Fixed effects regression models were applied. The ratio of total interest paid on long-term loans was used to calculate the cost of debts, and the ratio of cash and cash equivalents held to the total assets was used to calculate the accounting conservatism. The results showed that cash holding and accounting conservatism had a statistically significant positive correlation.

Abdurahman (2019) looked into the relationship between accounting conservatism and the cost of debt for African businesses. Firm-level data for the study was provided by 224 firms across 8 African countries between 2007 and 2018. They measured the level of conservatism reported by the firms and the cost of the debt capital of the firms using the Accrual-based measure of accounting conservatism model developed by Givoly and Hayn (2000). The cost of the debt capital was calculated as interest paid one year lag for the total amount of interest-bearing debt. The findings indicated a negative correlation between debt costs and accounting conservatism, with companies that were more conservative in recording their losses than their gains benefiting from low debt costs.

***Hypothesis:** Accounting conservatism has a positive relationship with firm value*

3. METHODOLOGY

The study employed ex post facto research design as the variables were linked to a specific kind of occurrence by analyzing past occurrences in previously established contexts. Asset tangibility and earnings to asset ratio were used as a stand-in for firm

structure, while earnings accrual was used as a stand-in for the variables of interest for accounting conservatism. The study made use of thirty-two manufacturing firms listed on the floor of the Nigerian Stock Exchange as at 2023.

Model Specification

$$ACC = \beta_0 + \beta_1 ATR_{it} + \beta_2 ETAR_{it} + \varepsilon_{it}$$

Where:

ETAR= Earnings to Asset Ratio;

ATR = Asset Tangibility Ratio;

ACC= Accruals

$\beta_0 - \beta_2$ = Coefficients of Regression;

e = Error Term;

i= 1, t = Time-Frame

4. RESULTS AND DISCUSSION

Descriptive Analysis

This study examined the impact of accounting conservatism (earning accrual) and firm structure (asset tangibility and earnings to asset ratio) of manufacturing firms in Nigeria. Accounting conservatism was measured using Accruals (ACC) while firm structure was proxied using Asset tangibility ratio (ATR) and Equity-To Asset Ratio (ETAR). Table 4.1 below shows the descriptive analysis for the data collection on each variable.

Table 1
Descriptive Analysis

	ACC	ATR	ETAR
Mean	8.534269	53.84041	503.1816
Median	3.455612	55.51703	44.35222
Maximum	101.4456	126.6744	20325.86
Minimum	0.009310	0.624593	-0.005575
Std. Dev.	17.25720	24.83596	2410.420
Skewness	4.136552	-0.118156	6.912976
Kurtosis	20.16736	2.165410	51.07204
Jarque-Bera	5326.382	11.03496	36697.15
Probability	0.000000	0.004016	0.000000
Sum	3004.063	18951.82	177119.9
Sum Sq. Dev.	104531.6	216505.6	2.04E+09
Observations	352	352	352

Source: E-views Version 10

Table 1 shows the descriptive statistics for the variables and as observed, the mean for asset tangibility (ATR) stood at 53.84041 with a standard deviation of 24.83596.

The maximum and minimum values stood at 126.6744 and 0.624593 respectively. Equity to Asset (ETA) has a mean value of 503.1816 and a standard deviation of 2410.420. The maximum and minimum values stood at 20325.86 and -0.005575 respectively. Accruals (ACC) has a mean of 8.534269 with maximum and minimum values of 101.4456 and 0.009310 respectively.

Correlation Analysis

The correlation statistics show the direction and strength of the relationships between the variables. Positive correlations show that an increase in one measure is associated with an increase in the other, and vice versa. The results of the Pearson correlation model are shown in Tables 4.2 below.

Table 2
Correlation Analysis

$$ACC = \beta_0 + \beta_1 ATR_{it} + \beta_2 ETAR_{it} + \varepsilon_{it}$$

Covariance	ACCRUAL	AT	ETA
Correlation			
ACC	296.9648 1.000000		
ATR	40.35235 0.094418	615.0727 1.000000	
ETAR	-2771.438 -0.066816	-6932.641 -0.116134	5793618. 1.000000

Source: E-views Version 10

ATR and ACC have a positive correlation, according to the Pearson correlation results ($r = 0.094418$). This indicates that ATR and ACC get along well. This suggests that higher asset tangibility ratios will result in higher accruals. ETAR and ACC have a negative correlation, according to the Pearson correlation results ($r = -0.066816$). This demonstrates the inverse relationship between accrual and the equity to asset ratio. Thus, a higher equity to asset ratio will result in a lower accrual

Unit Root Test

To determine whether the variables are stationary, the unit root test is run. Table 4.4 below displays the panel unit root test summary.

Table 3
Summary of Panel Unit Root Test for ACC Model

Levels						REMARK
	Levin, Lin & Chu t*	Im, Pesaran and Shin W-stat	ADF – Fisher Chi- square	PP – Fisher Chi- square	LEVEL OF INTEGRATION	
ACC	0.0000	0.0000	0.0000	0.0000	I(0)	STATIONARY
ATR	0.0000	0.0000	0.0000	0.0000	I(0)	STATIONARY
ETAR	0.0000	0.0000	0.0000	0.0000	I(0)	STATIONARY

Source: E-views Version 10

Test of Hypotheses

This study looks at accounting conservatism and the organizational structure of manufacturing companies in Nigeria. Using E-views version 10, panel regression analysis was used to evaluate the provided hypotheses. The results are described in Table 4 below.

Table 4
Panel Regression Analysis for Accrual Model

$$ACC = \beta_0 + \beta_1 ATR_{it} + \beta_2 ETAR_{it} + \epsilon_{it}$$

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	8.550199	0.203436	42.02904	0.0000
ATR	0.000266	0.003605	0.073722	0.9413
ETAR	-6.01E-05	5.06E-05	-1.187409	0.2360
Effects Specification				
Cross-section fixed (dummy variables)				
Weighted Statistics				
R-squared	0.892835	Mean dependent var	17.35503	
Adjusted R-squared	0.881714	S.D. dependent var	19.29380	

S.E. of regression	6.881994	Sum squared resid	15061.07
F-statistic	80.28458	Durbin-Watson stat	1.394691
Prob(F-statistic)	0.000000		
Unweighted Statistics			
R-squared	0.845236	Mean dependent var	8.534269
Sum squared resid	16177.69	Durbin-Watson stat	1.821378

Source: E-views Version 10

The adjusted R squared for the regression model was 0.881714. The F-statistic of 80.28458 (p-value = 0.00000) at 5% indicates that the hypothesis that there is a significant linear relationship between the dependent and independent variables cannot be rejected. Additionally, it displays the total statistical significance of the model.

The coefficient analysis shows that the Asset Tangibility Ratio (ATR) has a positive coefficient value of 0.000266 effect on accruals. At 5%, this effect is statistically negligible (p= 0.9413). This implies that when the asset tangibility ratio rises, accruals will also rise. This suggests that accruals are slightly positively impacted by the asset tangibility ratio. The equity to assistant ratio, with a p-value of 0.2360 and a negative coefficient value of -6.01, is statistically not significant at 5%. This implies that accruals increase in tandem with an increase in the equity to asset ratio, indicating that the equity to asset ratio has little adverse effect on accruals.

Table 5
Cross Sectional Dependency Test for ACC model

Test	Statistic	d.f.	Prob.
Pesaran scaled LM	13.54930		0.0000
Pesaran CD	1.709571		0.0873

Source: E-views Version 10

The above result suggests that there is either no cross-sectional dependence or cross-sectional independence in the residuals because the Pesaran CD test statistic is 0.0873, which is greater than 0.05.

Discussion of Findings

This study examines the impact of accounting conservatism (earning accrual) and firm structure (asset tangibility and earnings quality ratio) in Nigeria manufacturing firms. The research hypotheses were tested using both correlation and panel regression analysis. The result of the analysis shows that asset tangibility ratio has a positive insignificant effect on Accruals. This outcome is consistent with the research conducted by Ogiriki et al. (2022) to evaluate the connection between firms' capital structure in Nigeria and accounting conservatism. The study demonstrates that the business structure is favorably and considerably impacted by the degree of accounting conservatism, and that this impact is the result of debt issuance. Yong (2018) also investigated the relationship between capital structure adjustments made by businesses and accounting conservatism. The outcome demonstrates that companies with more cautious financial reporting swiftly modify their capital structure to reach the goal, particularly those that depend more heavily on outside financing for modifications. The relationship between cost of equity capital and accounting conservatism was examined by Tracy and Peter (2013). Despite the growing opposition of accounting standard setters to conservatism, this evidence suggests that there are economic advantages to adopting conservative reporting procedures. As a result, we can infer that conservatism plays a beneficial role in accounting principles and practices.

Equity of asset ratio has a negative insignificant effect on Accruals. This is correlated with Abdurahman (2019) investigation who looked at the connection between the firms cost of debt and accounting conservatism in the context of an African firm. The results showed a negative relationship between accounting conservatism and loan costs; companies that practice strong accounting conservatism by reporting more losses than gains have lower debt costs. Additionally, Beng et al. (2017) conducted research to determine how much debt and conditional conservatism affect equity financing. The findings imply that conservatism lessens information asymmetry more between companies and their debt holders than it does between them and their shareholders. The relationship between accounting conservatism and the cost of equity capital was empirically analyzed by Xiang and Shiping (2017). The findings indicated a general level of accounting conservatism among China listed companies, and that the more accounting conservatism the less information risk investors face and the lower the required rate of return on investment, which lowers the cost of equity capital. The association between capital structure and accounting conservatism of companies listed on the Tehran Stock Exchange was examined by Abbas et al. (2013). The findings of the research shows that the capital structure of

the enterprises under investigation, that is, the ratios of debt to equity and debt to total assets and conservative accounting have an adverse connection.

5. CONCLUSION AND RECOMMENDATIONS

Numerous studies have examined the relationship between accounting conservatism and firm structure in the accounting literature, but there has not been much discussion of how accounting conservatism affects firm structure in general or its asset structure in particular for publicly traded manufacturing companies in Nigeria. The study looked at the relationship between listed manufacturing firms in Nigeria from 2012 to 2022 and accounting conservatism and firm structure in the light of a gap in the literature. Earnings quality and ROA/Accruals were used to gauge accounting conservatism, whereas asset structure that is, asset tangibility was used to gauge company structure. ROA/Accruals have a negative insignificant effect on asset tangibility, it also showed that Earnings Quality has a positive insignificant effect on asset tangibility. Based on the conclusion above, the study recommends that; accounting regulatory framework and businesses should make sure that a process is put in place that is intended to ensure that firms strictly use accounting conservatism, and that enterprises that make mistakes are required to suffer harsh penalties; that companies should increase the number of non-executive directors on their board in order to provide the necessary assurance for improved financial reporting.

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