Accounting Conservatism and its Benefits to Shareholders in Developing Capital Market: Evidence from Nigeria

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Abstract
This study investigated the relationship between accounting conservatism and shareholders value of selected quoted companies in Nigeria. The proxy for accounting conservatism was asymmetric accrual to cash-flow (AACF) and shareholders fund was the proxy for shareholders value. Exchange and inflation rates were included as control variables. This study adopted ex-post facto research design. The population of the study was all quoted companies on the Nigeria Stock Exchange from which a sample of 20 companies was chosen using judgmental sampling technique. Secondary data was obtained from annual report and accounts of the sampled companies for a period of ten years (2006 to 2015). Multiple regression analysis was used to analyze the data collected. The hypothesis was tested using F-Statistic. The result of the study revealed existence of a significant positive relationship between accounting conservatism and shareholders value with F-statistic p-value of 0.016 for all our explanatory variables. This result was validated with robustness checks and it was discovered that the relationship between conservatism and shareholders value was high for firms with higher information asymmetry. The finding implies that accounting conservatism is an efficient governance mechanism to mitigate information risk and control for agency problems. Hence, we concluded that shareholders derive benefits from accounting conservatism practice in Nigeria.

Keywords: *Accounting conservatism; Shareholder value; Quoted companies*

INTRODUCTION

Accounting conservatism is known for years as an important principle in corporate reporting, but this principle had over the years been assessed by policy makers and players in the capital market for its merits and demerits. Example of such assessors is the Financial Accounting Standard Board (2010) who removed conservatism from their conceptual framework because they opine that conservatism could lead to information asymmetries which negate the quality of neutrality. In the same vein, scholars such as Penman and Zhang (2002) assert that conservatism accounting could lead to subjective resource allocation and in effect reduce firm value which on the long run affects the equity pricing of such firm. No wonder that Zhuo and Lobo (2006) concluded that the practice of accounting is conservative.

Despite the shortcomings of accounting conservatism, it is gaining popularity because of many benefits derivable from conservative accounting practice which may not be known to the policy makers and regulators (Watts, 2003). Conservative accounting would lead to conservative corporate reporting which has effect of diminishing the shareholders' funds of the company. This in effect helps to reduce dangers associated with earnings overstatement and understatement of stock value.

In the words of LaFond and Watts, (2008); LaFond and Roychowdhury, (2008) "due to separation between ownership and control of companies, it is a common practice for dubious management team to overstate the value of net worth of firm and its earnings in order to satisfy their personal interests". However, according to Basu (1997) accounting conservatism helps to reduce the risks associated with this dubious practice by management of firms.

It is asserted by Ahmed and Duellman (2011) that companies practicing conservatism accounting would have comparatively low value losses in period of financial crisis to companies that do not practice it. This is owing to the fact that managers are more likely to be aggressive in earnings strategies during crisis time (Kim and Yi, 2006). Manipulations of earnings would pose information and agency risks on users of accounting information such as shareholders and this may lead to unfavorable performance in times of crisis (Mitton, 2002). "The asymmetric confirmation requirements embedded in conservative accounting limit managerial earnings manipulations thereby providing more reliable and transparent accounting information to shareholders" (Watts, 2003). According to Li (2010) conservative accounting help to reduce debt financing cost; increase investment returns and enhance cash holding value of firms.

In spite of the acclaimed economic merits of conservatism according to Zang (2008) and other scholars, there is little study on conservatism accounting benefits to owners of companies in Nigeria.The importance of conservatism accounting cannot be overlooked in Nigeria especially in this period of economic recession which has eaten deep into every area of investments. Hence, the need for this study which investigated the relationship between accounting conservatism and shareholders values of selected quoted companies in Nigeria.

The rest of this paper is structured as follows: The second section deals with literature review. The third section contains the methodology. The fourth section deals with data analysis and presentation as well as discussion of findings. And the fifth section provides conclusions and recommendations.

LITERATURE REVIEW

The precise meaning of the construct of accounting conservatism is yet to be universally agreed upon by researchers in the field of accounting. According to International Accounting Standard Board (1989) conservatism is "a degree of restraint in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or incomes are not overstated and liabilities or expenses are not understated". Another regulatory accounting body, The Financial Accounting Standards Board (2010) defined conservatism as "possible error in measurement that should be in the direction of understatement rather than overstatement of net income and net assets of firm". Watts (2003) refers to accounting conservatism "as the differential verifiability required for profit recognition versus losses". LaFond and Watts (2008); Bushman and Smith (2001); and Sloan (2001) assert that conservative accounting is an efficient management tool in controlling agency problems and that conservatism has a crucial role in mitigating information asymmetries.

Mitton (2002) assert that "when the economy is good, investors may not give much attention to the quality of earnings because of many available investment opportunities in the economy. Nonetheless, economic recession could lead investors to recognize the weakness in earnings quality that existed all along in any company where such exist". This awareness in earning quality weakness could make a firm to run to safety, hence reducing shareholders' funds. Prior studies such as Francis, Husan, and Wu (2012) concluded that such moves by firm would negatively affect stock market price. Also, Allen and Carletti (2008) reiterate that in crisis situation, fair value accounting involves lots of manipulations which do not give a true and fair value of the financial statements of firms. The practice of conservative accounting makes accounting information to be more reliable and have substance.

From the aforementioned, it could be concluded that conservatism prevents firm value losses especially in period of financial crisis and that conservatism could furthermore affect shareholders' fund through its impact on financing, investments and others. It is suffice to state that timely recognition of losses than gains can make shareholders and boards of directors to quickly identify unviable projects and thereby make the management to take a decision to discontinue them. This discontinuity of unprofitable segments of the firm would not allow their poor performance to erode the profitability of viable segments of the firm which has a consequential effect on the value of the firm (Bleck & Liu, 2007; Francis & Martins, 2010; Ahmed & Duellman, 2011).

According to Watt (2003) “positive accounting theory states that accounting conservatism is an efficient contracting and governance mechanism to mitigate information asymmetries and solving problems associated with agency”. In the work of Li (2010), it was concluded that conservatism increases both current and future cash flows of a company. Also, the study conducted by Louis, Sun and Urcan (2012) revealed that conservatism reduces agency problems associated with high cash holding which result to cash wastage in operation and investment. Ahmed and Duellman (2011) found that firms with more conservative accounting have higher future cash flows and gross margins and lower likelihood and magnitude of special items charges than firms with less conservative accounting. Bill, Iftekhar &Qiang (2013) concluded in their studies that conservatism has a significant relationship with firm value most especially in crisis period. This is common with companies that do not have strong corporate governance and companies that have high information asymmetries. In the work of Biddle, Ma and Song (2011) it was found that a negative relationship existed between conservatism and operating cash flows. They concluded that conservatism is a risk management tool in a firm.

METHODOLOGY

This study adopted ex-post facto research design. This design was adopted as it was found appropriate for achieving the research objectives of this study.. The population of this study covers all quoted companies on the Nigeria Stock Exchange for a period of 10 years (2006-2015). Twenty quoted companies were selected using judgmental sampling. We collected data from the annual reports and accounts of the selected companies. The sample of this study was 20 companies. The study adopted judgmental sampling method; this was used to select 20 out of the number of companies representing each section. The choice of the listed companies is due to the fact that The Nigeria Stock Exchange is authorized by Security and Exchange Commission(SEC) to provide listing services and platform for primary and secondary trading of stocks therefore any listed companies would have met all listing conditions and their corporate reports were deemed reliable for evaluation and decision making. Collectively, we hypothesized that:

H_0: *There is no significant relationship between accounting conservatism and shareholders value of quoted companies on Nigeria Stock Exchange.*

Variable Description

In this study our primary measure of conservatism was the Asymmetric Accrual to Cash-flow Model (AACF) as proposed by Ball and Shivakumar (2005). This model was developed in order to estimate the degrees of accounting conservatism in listed companies. The Basu’s AT measure of 1997 is not totally suitable for listed companies, because these companies have no quoted stock prices. To overcome this problem, Ball and Shivakumar (2005) proposed the AACF measure of conservative accounting as a stock-market version of the Basu’s AT measure of 1997. The AACF measure is based on cross-sectional regression but for the purpose of our study the model shall be based on panel regression, this is because we want to confirm whether our findings will differ from prior literatures that had made use of cross-sectional regression. We hope to provide a more robust and more generalized opinion on our findings, hence the use of panel regression.

$$ACC_{it} = \alpha_0 + \beta_1 DCFO_{it} + \gamma_1 CFO_{it} + \sum_1 DCFO_{it} * CFO_{it} + \mu_{it} \dots\dots\dots\dots 1$$

Where;

ACCit: Accruals measured as Δ Inventory + Δ Debtors + Δ other current assets - Δ Creditors - Δ other current liabilities – Depreciation.

CFOit: Cash-flow for period t and company i

DCFOit: Dummy variable that is set to 0 if 0 ≤ CFOit and is set to 1 when 0 >CFOit. (this dummy variable is used to distinguish between good-news and bad news). To capture the overall information asymmetry of a firm, we first construct a dummy variable called DCFO (this dummy variable is used to distinguish between good-news and bad news and its effect on corporate performance as opined by Richard, Ciaran & Tony (ND). for the purpose of this study we use this as part of our proxies to measure the effect of conservatism on shareholder value instead of corporate performance as previously used in prior literatures.

$DCFO_{it} * CFO_{it}$: captured the incremental effect of information asymmetry (conservatism) on shareholder value.

Note: this model (AACF Measure) uses operating cash-flow as the proxy for news unlike the Basu AT model that used stock return.

On the other hand we measured shareholders' value using the total fund available to the equity holders i.e. shareholders' fund.

$$SV = SF_{it} \ldots\ldots\ldots 2$$

$where$:
$SV\ is\ the\ shareholder\ value$
$and\ SF\ is\ the\ shareholders'fund\ for\ company\ i\ in\ time\ t.$

Control Variables

In this study we used Inflation and Exchange rate as control variables. This is because these two control variables are assumed to directly affect the financial performance of any company by their fluctuations. Any upward movement/increase in these two variables is expected to negatively affect the performance (shareholder's value) of the companies under study while an opposite effect is expected for any downward movement in these variables. The control variables are inflation rate and exchange rate over the years under review. The introduction of our control variables becomes a paramount necessity, due to the specific nature of the country (Nigeria). Hence our new conservatism equation and regression model is given below in equations 3 and 4 respectively:

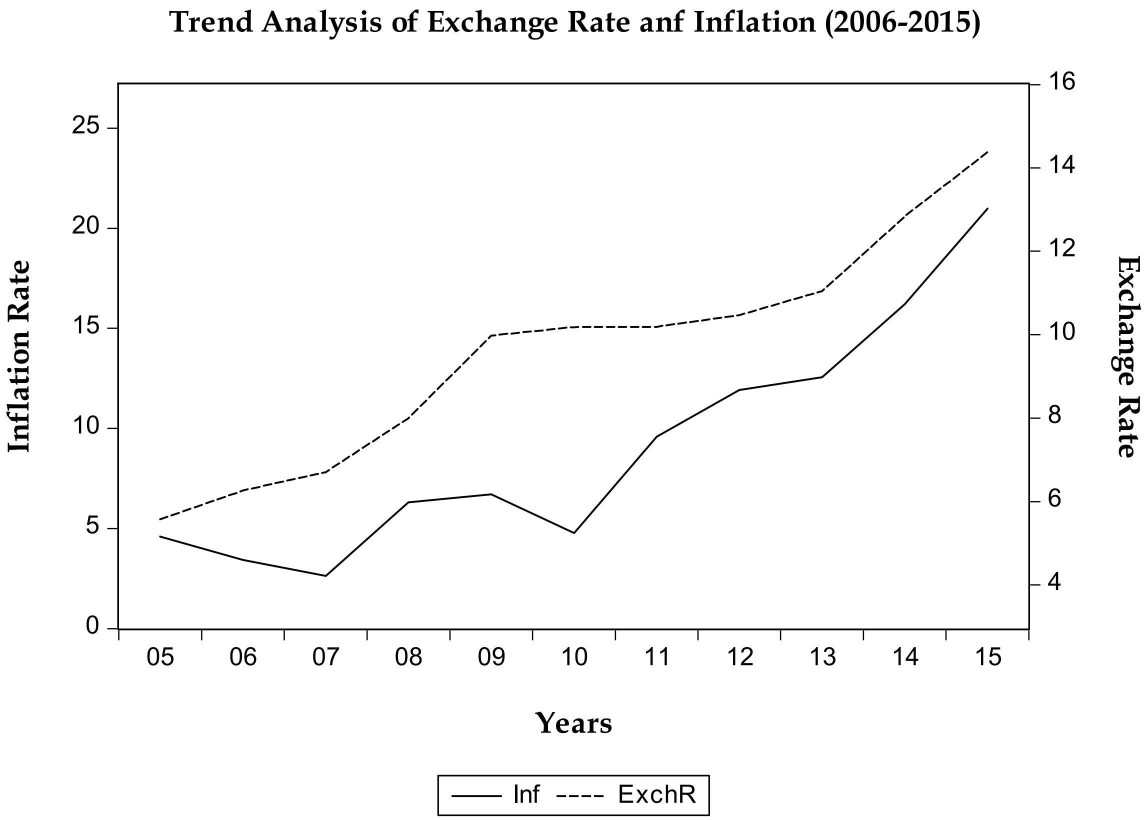
$$ACC = DCFO_{it} + CFO_{it} + DCFO_{it} * CFO_{it} + Inf_t + ExhR_t \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots 3$$

$$SF_{it} = \alpha_0 + \beta_1 DCFO_{it} + ɣ_1 CFO_{it} + \sum_1 DCFO_{it} * CFO_{it} + £_1 Inf_t + ¥_1 ExhR_t + \mu_{it} \ldots\ldots\ldots 4$$

DATA ANALYSIS, PRESENTATIONS AND DISCUSSION OF FINDINGS

Graphical Representation

Figure 1



The figure 1 above is a graphical illustration of our control variables, it shows the trend analysis of the variables (inflation rate and exchange rate). It shows that over the years under review (2006-2015) both variables have been experiencing a continuous increase. This upward movement is expected to have an inverse effect on the financial performance which in return will indirectly affect the shareholders' value. This is because inflation and exchange rate reduce will the expansion of trade flow which will later affect (reduce) the operations of the companies as a result of unfavorable exchange rate.

Table 1: Regression Estimate

Variable	Main Model			
	Coefficient	Std Error	t-Stat.	Prob.
C	1.164	0.708	1.645	0.104
DCFO	0.083	0.161	0.518	0.126
CFO	0.465	0.134	3.481	0.001*
DCFO*(CFO)	0.055	0.166	0.329	0.743
INF	- 0.287	0.134	2.140	0.035*
EXHR	- 0.284	0.058	4.834	0.016*
R^2	0.6304			
Adj. R^2	0.5703			
S.E of Reg	0.8632			
F-Statistic	8.9601			
Prob.(F-Stat)	0.0164*			

Dependent Variable: SF *significance at 5%

Source: Researcher's STATA output 2016.

$$SF_{it} = 1.164 + 0.083DCFO_{it} + 0.465CFO_{it} + 0.055DCFO_{it} * CFO_{it} - 0.287Inf_t - 0.284ExhR_t + \mu_{it}$$

Table 1 above shows the multiple regression results of our model indicating that there exists a positive relationship between shareholder value and conservative accounting practice of companies in Nigeria evidence from our selected sample size, only our control variables are showing a negative effect which is also in line with a priori expectation. This is indicated by the sign and size of all the coefficients for DCFO which is $\beta_1 = 0.083 > 0$. While CFO, DCFO*CFO, INF and EXHR have a coefficient of 0.465, 0.055, - 0.287 and - 0.284 respectively these are greater than 0 except the coefficients of Inflation (Inf) and Exchange rate (ExhR) which is then in line with our a priori expectation. From the multiple regression estimates on table 1 above, the Adjusted R-squared shows that about 57% variations in shareholder value can be attributed to the influence of all our explanatory variables (accounting conservatism) while the remaining 43% variations in the explained were caused by other factors not included in this model.

Furthermore, the coefficients of cash flow (CFO) shows ₦1 change (increase) in CFO will cause a positive 0.465 naira increase in shareholders' fund; one percentage increase in inflation will cause a negative 0.287 naira decrease in shareholder value of our selected companies. While a one Naira increase in exchange rate will also cause a 0.284 naira decrease in shareholders' value. Looking at the individual effect of our explanatory variables on shareholder value (measured by shareholders' fund), we found out that cash flow and our control variables (Inflation and Exchange rate) had a significant positive effect on the explained variable. From table 1 the coefficient of our proxy for information asymmetry (DCFO) is 0.083 which is not significant at 5%, This shows that bad news may not negatively affect the performance (shareholders value) of companies, because of good communication between the company and those that have interest in it.

While other variables (DCFO and DCFO*CFO) individually, do not have a significant relationship with shareholders fund, i.e. an increase in the bad news in the economy (crises period) will not negatively affect the performance (Shareholder value) of the selected companies because of non-existence of a significant information asymmetry in the company. Also, the F-statistic p-value showed 1.6% for all our explanatory variables meaning that the multiple regression result are statistically significant because this (the p-value) is less than 5%, which is the level of significance adopted for this study. This shows that the influence of conservative accounting on shareholder value is statistically significant. Therefore, we rejected the null statement of the objective the present study set to achieve.

CONCLUSION AND RECOMMENDATIONS

From the regression results, it could be concluded that accounting conservatism is significantly and positively affected by shareholder value even in period of recession. In the regression table, we found that the coefficient of DCFO*CFO is 0.055. This shows that conservatism had a significant effect on shareholders' fundsin this period of economic recession in Nigeria. The result indicates that, on average, the companies that are conservative will at all times (crisis or no crisis) report a better performance compared to other counterparts that are not conservative in their financial reporting practices. This conclusion is in line with the work of Bill et al (2013). This implies that the market value of companies practicing conservative accounting is enhanced.

This study also provides confirmation to the opinion of Watts (2003) that standard setters should be careful in eradicating conservatism and moving toward fair value in reporting assets and liabilities.

Finally, we cannot rule out the measure-error problem, perhaps we are yet to exhaust all proxies of conservatism. Areas of further research could be the investigation of the effect of conservatism on operations of companies and how investment is affected during recession period.

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