





# AUDIT FIRM MECHANISM AND ACCOUNTING CONSERVATISM IN NIGERIA

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## ABSTRACT

*The aim of the study was to examine the effect of audit firm mechanism on accounting conservatism in Nigeria. The study made use of ex-post facto research design for the collection of secondary data. The population for the study consisted of listed health and pharmaceutical firms in Nigerian Exchange Group (NSG) as at 31<sup>st</sup> December, 2022. The sampled firms must fulfill the responsibility of disclosing their financial statements for eleven consecutive years for the period 2012- 2022. The filtering method of sample selection was used to select six (6) health and pharmaceutical firms. The study adopted the use of least square regression technique in the analysis of data. The regression results show that audit fees have a significant positive effect on accounting conservatism at 1% level of significance, audit quality has no significant and negative effect on accounting conservatism, and audit committee existence has a significant and positive effect on accounting conservatism. The study recommends that the policymakers of health and pharmaceutical companies in Nigeria should motivate the external auditor in terms of audit incentives for purpose of enhancing accounting conservatism.*

**Keywords:** Accounting Conservatism, Audit Fees, Audit Quality, Audit Committee Existence and Audit Report Lag.

## 1.0 INTRODUCTION

Accounting conservatism (ACC) is a potential quality of earnings management (EM). Nwoye, et al. (2020) disclosed that in the field of ACC, EM issues is an area that had been broadly and extensively studied since the last two decades because the subject matter is believed to be the vital ethical problem militating against the accounting line of work. This principle of accounting conservatism had been debated by contemporary academicians, scholars and accounting standard setters that the accountants should apply the principle of prudence in the preparation of financial statement through the recognition of transactions caused by economic uncertainty. Emudainohwo (2021) posited that conservatism of accounting information is a kind of corporate disclosure planned by corporate managers, presented to corporate stakeholders as well as financial statement users for the achievement of private benefits.

Accounting practitioners debated that conservatism had greatly increased the recognition of losses and decreased recognition of revenue (Watts, 2003). Oyedokun, et al. (2020) stated that firm's ability to survive in the future as the world's economies are becoming more and more globally integrated depends on the acceptable returns in the competitive global market. Audit firm mechanism serves as a monitoring mechanism explored by health and pharmaceutical companies to minimize moral hazard caused by [information asymmetry](#) (Jensen & Meckling, 1976). Monametsi and Agasha (2020) added that audit mechanism helps to ensure that financial statements of quoted companies are reliable, faithfully represented, comparable, understandable, and credible to enhance market confidence. Hamid and Suzana (2013) argued that auditing mechanism brings about public confidence in the credibility of the audit process and financial reporting in order to reduce the level of ACC.

Zhong and Li (2017) argued that ACC is always present in the preparation of financial statement of corporate organization and it cannot be disregarded. Olojede, et al. (2020) attributed the causes of the high profile scandals of highly rated corporations globally in the last decade to include ineffective and poor corporate governance, weak institutional framework in regulation, compliance and enforcement of relevant standards and rules as well as the practice of EM by corporate managers. Mamidu and Oladutire (2023) stressed that the conservatism of accounting information is the prime cause of corporate failures as a result of the poor audit quality. The mechanism explored by accountants in recognition of economic gains rather than losses is the practice of Accounting conservatism (Ahmed & Duellman, 2011). The broad objective is to investigate the effect of audit fees, audit quality, audit committee existence and audit report lag on accounting conservatism in Nigeria.

## 2.0 LITERATURE REVIEW

### 2.1 The Concept of Accounting Conservatism

Accounting conservatism (ACC) is a principle of accounting and practice explored by accountants to minimize the falsification of financial figures that create a wider gap in asymmetry of financial statements information for proper dissemination of accounting information. Wolk, et al. (2013) defined ACC as the process of choosing between generalized accounting practices that bring about underestimation of the assessment of assets or the overestimation of the assessment of debts. Krismiaji (2021) argued that slackening down of income acknowledgement, fast-tracking acknowledgement of expenditures and pulling down of asset assessment and increasing obligation appraisal is the rudiment of accounting ideologies arising from conservatism of accounting information. Lara, et al. (2012) affirmed that conservatism is an instrument of accounting practice used to address the tendency of earnings management in financial statement. Conservatism and fair value accounting mainly deals with recognition of revenue and losses brought by earnings management. Mamidu and Oladutire (2023) added the existence of worsening carrying value of assets when compared to its market value from one accounting period to another based on prior period. In this study, ACC is seen as the misleading information in the recognition of income in relation to gains and losses of value assets.

### 2.2 Audit Firm Mechanism

The audit mechanism variables explored in this current study were audit fees, audit quality, audit committee existence and audit report lag. These potent variables might influence accounting conservatism among listed health and pharmaceutical firms in Nigeria.

#### 2.2.1 Audit Fees and Accounting Conservatism

The presence of audit firm commanding higher audit fees is signal for auditors to carry out audit function effectively for the purpose of detecting and preventing earnings manipulations and to improve the level of audit quality (Abu-Ijela & Hamdan, 2010). Akrawah and Akhor (2016) defined as the sums payable to the auditor, for carrying out audit services offered to the auditing company. Chersan (2019) maintained that amount paid for audit is questioned as audit quality provided by

the financial auditors have become a growing issue over the last few years, especially due to the financial scandals, where the role of auditors has sometimes been direct.

Hamdan, et al. (2012) examined the relationship between auditing quality and ACC in Jordan. The aim is to examine the relationship between audit firm size, global auditing firms, client retention period, auditing fees and client's specialization industry and ACC with the following control variables (company size, financial leverage, audit committee members and audit committee experience. They sample 39 listed industrial companies for the period of 2001 to 2006 and multiple regressions is used to test the hypotheses. The result showed that audit fees and global auditing firms had insignificant relationship with ACC while client retention period and client's specialization industry had significant relationship with ACC. The control variables, company size, financial leverage and audit committee members had significant relationship with ACC while audit committee experience had insignificant relationship with ACC. Ugbah (2024) used a sample of 20 listed insurance companies for the period of 2016 to 2022 to investigate the relationship between audit firm characteristics and earnings management in Nigeria. The result of generalized linear regression technique reveals that audit fees, auditor switching and auditor quality had no significant relationship with earnings management while auditor experience has a negative and significant with earnings management at 5% level of significance. Based on the following, the proposed hypothesis is:

*Hypothesis 1: Audit fees have a significant effect on accounting conservatism in Nigeria.*

### **2.2.2 Audit Quality and Accounting Conservatism**

Audit quality has the tendency of enhancing decision making for ensuring that the information of accounting reports is relevance and reliable for the users of financial statements (Yopie & Elivia, 2022). Imade (2021) defined audit quality as the systematic process of examining the quality system of internal control by an internal or external auditor of an organization. According to Hammami and Zadeh (2020), audit quality is assumed as the accuracy of accounting information reported to the intended users for the promotion of financial strength and informed financial investments. Abu- Afifa,etal.(2023) studied the mediating effect of earnings management on the relationship between audit quality and company value in Jordan. Data were collected from some selected Jordan listed firms and descriptive statistics, correlation and ordinary regression adopted in the analysis of data. The findings revealed that audit quality is negatively related to earnings management manipulation. Awuye and Aubert (2022) studied the impact of audit quality on earnings management as a predictor of accounting conservatism in France. AQ was proxies by Big4 and non-Big4 while EM proxies by real and accruals earnings management estimation and data was analyzed using multivariate regression techniques. The empirical evidence revealed that audit quality has a significant positive

Impact on earnings management. Hejranijamil, et al. (2020) conducted a study on the relationship between accounting conservatism and earnings quality in Tehran. The result showed that a significant negative relationship between accounting conservatism and audit quality proxies value relevance. Based on the following, the proposed hypothesis is:

*Hypothesis2: Audit quality has a significant effect on accounting conservatism in Nigeria.*

### **2.2.3 Audit Committee Existence and Accounting Conservatism**

The responsibility of audit committee (AC) in a company is to oversee the financial reporting process by ensuring timely disclosures of financial statements to users of accounting information. Audit committee existence is proxy by the frequency of AC meeting which is paramount of an effective board of directors Vafeas (1999) cited in Alabi, et al. (2022). Therefore, Audit committee existence is the frequency of meeting of the AC for enhancing the commitment of members of the AC in carrying out their knowledgeable obligations within the corporate organization. They argue that all members of the committee should be financially literate and at least one member should have an accounting or related financial management expertise. ElMahdy, et al. (2020) examined the effect of AC characteristics on accounting conservatism in Egypt. They sample 100 listed firms in the Egyptian stock market for the period of 2009 to 2019. The regression reveals show that AC financial expertise, diligence (existence) and interlock (size) had a significant effect on accounting conservatism. Sultana (2015) studied the relationship between AC characteristics and accounting conservatism in Australia. The regression results showed that frequency of AC meetings had a significant positive relationship with accounting conservatism. Based on the following, the proposed hypothesis is:

*Hypothesis 3: Audit committee existence has a significant effect on accounting conservatism in Nigeria.*

### **2.2.4 Audit Report Lag and Accounting Conservatism**

The audit report is the end product of every audit assignment that the auditor issues to the members of a client company expressing his opinion on the truth and fairness view regarding an enterprise's financial statements. However, delay in the disclosure of financial information jeopardizes the relevance of financial reporting by not providing timely information to the shareholders and institutional investors. Jura and Tewu (2021) argued that accounting information disclosed that is accurate, realistic as well as beneficial information may be considered immaterial if the information did not get to the end users when they needed it, therefore, delays in delivery of corporate reports may expose corporate organizations to unfavorable or unpleasant circumstances like negative or astonishing reaction from the market, encourage information asymmetry as well as promoting irregular investment decisions. Companies reporting beyond the stipulated timeframe of 90 days, will experience some consequences such as lack of investor's confidence, signal of earnings

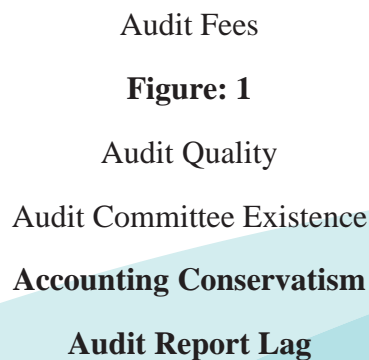
management, low value relevance of the accounting information, poor signal to users about a firm's financial conditions (Zandi&Abdullah,2019). Based on the following, the proposed hypothesis is: *Hypothesis4: Audit report lag has a significant effect on accounting conservatism in Nigeria.*

### 2.3 Theoretical Framework

The agency theory is used as the foundation of this study because of its total alignment to this study. The theory was developed by Jensen and Meckley in the year 1976. The principle of conservatism is usually associated with the agency theory in relation to management intention of not having personal incentives being conserved in the audited financial statement because they do not command huge investments in the company that would make them practice earning Management in the reporting of abnormal profits as agents of the shareholders (Li, et al.,2017). There is considerable information asymmetry between the agent and the principal. Auditors serve to reduce agency costs by reducing this information asymmetry. The underlying principle of this theory in the field of accounting conservatism is the reduction of agency conflicts and financial manipulations, discouraging opportunistic conduct in connection with corporate governance practice and integration of conservative accounting standards (Hajawiyah, et al., 2020).

### 2.4 Conceptual Framework

The diagram is used to demonstrate the effect of audit firm mechanism on accounting conservatism.



Audit Fees

#### Figure: 1

Audit Quality

Audit Committee Existence

Accounting Conservatism

Audit Report Lag

Source: Author's Conceptual Framework (2024)

## 3. METHODOLOGY

The study used longitudinal research design to collect secondary data. The sample population is made up of all listed health care and pharmaceutical companies as at 31st December, 2022. The simple random sampling technique was employed to sample six (6) from the total population of eight (8) companies: Fidson Healthcare Nigeria Plc, Glaxosmikline Nigeria Plc, May and Baker Nigeria Plc, Morison Industries, Neimeth International Pharmaceutical, Pharma Deko Nigeria Plc while Evans Medical Nigeria Plc and Union Diagnostic annual reports are not available for the sampled



periods (2012 to 2022). The data collected were analyzed using descriptive statistics, correlation analysis and multiple regressions technique with aid of EViews 9.0.

**3.1 Model Specification and Measurement of Variables**

The multiple regressions model was employed in the study. The study adapted the model of Soliman (2014) which is stated in equ. (3.1).

$$ACCON = \beta_0 + \beta_1 ASIZ + \beta_2 ASP + \beta_3 ATEN + \beta_4 CSIZ + \beta_5 LEV + \beta_6 ROA + \beta_7 FSU + \epsilon \tag{3.1}$$

Where:

ACCON=Accounting conservatism index,

ASIZ = audit firm size;

ASP=auditor specialization in the client's industry; ATEN= auditor tenure;

CSIZ=company size;

LEV=firm's financial leverage;

ROA=firm's profitability;

FSU=firm survival;

$\epsilon$ ,=error term, normally distributed about a mean of 0.

The adapted model is re-specified in equ.(3.2) below;

$$ACC_i = \beta_0 + \beta_1 AUDF_i + \beta_2 AUDQ_i + \beta_3 ACE_i + \beta_4 ARL_i + \dots \tag{3.2}$$

ACC=Accounting conservatism.

AUDF=Audit fees.

AUDQ=Audit quality.

ACE=Audit committee existence.

ARL=Audit report lag.

$\beta$  = variables that vary across companies but do not vary over time= error terms over the cross section and time.

The presumptive signs of the parameters in the specifications are:

$$\beta_1, \beta_2, \beta_3, \beta_4 > 0$$

**3.2 Measurement of Variables**

The measurement of variables is presented in Table 1 below.

**Table1: Measurement of Variables**

SN	Variables	Definition	Measurement	Apriori sign
1	ACC	Accounting conservatism (dependent variable)	It was measured by accrual method: Income + depreciation – net operating cash flow/total asset	
2	AUDF	Audit fees (Independent variable)	It was measured by the audit fees charged by the audit firm of company i in year t	+
3	AUDQ	Audit quality (Independent variable)	It was measured by a dummy variable:“1” if client firm is audited with the Big 4 [Deloitte, Klynveld Peat Marwick Goerdeler (KPMG), Ernst & Young and Price water house coopers (PWC)] OTHERWISE “0”.	+
4	ACE	Audit committee existence (Independent variable)	It was measured by the frequency of audit committee meeting	+
5	ARL	Audit report lag (Independent variable)	It was measured by the difference between auditor report date and company year-end (measured with number of days)	+

#### 4.0 RESULTS AND ANALYSIS

The analysis of result is based on descriptive statistics, correlation analysis and regression analysis.

##### 4.1 Descriptive Statistics

Table 2 presents the summary of descriptive statistics of the sample firms. The mean value of accounting conservatism (ACC) is -0.0158 and a standard deviation value of 0.1785. The negative value indicates that Nigeria health and pharmaceutical firms practice lower accounting conservatism. Audit fees (AUDF) have a mean value of N10196.23 million and a standard deviation value of 7037.99. Audit quality (AUDQ) has a mean value of 0.3593 and a standard deviation value of 0.4836. Audit committee existence (ACE) has a mean value of 4.0937 and a standard deviation value of 0.8303 while Audit report lag (ARL) has a mean value of 92.3125 and a standard deviation value of 19.7924. The result of the skewness showed that all the variables are positively skewed. However, the Jarque-Bera statistics affirmed that all the variables are normally distributed at p-value <0.05. The result is presented in the Table 2 as shown below.

**Table2 Descriptive Statistics**

	ACC	AUDF	AUDQ	ACE	ARL
Mean	-0.015844	10196.23	0.359375	4.093750	92.31250
Median	-0.033400	8947.000	0.000000	4.000000	88.00000
Maximum	0.890500	28500.00	1.000000	6.000000	148.0000
Minimum	-0.365900	2000.000	0.000000	3.000000	59.00000
Std.Dev.	0.178587	7037.997	0.483610	0.830352	19.79247
Skewness	2.640542	0.947145	0.586161	0.998462	1.344903
Kurtosis	14.01074	3.202365	1.343584	3.809354	4.438974
Jarque-Bera	397.6699	9.678093	10.98147	12.38069	24.81522
Probability	0.000000	0.007915	0.004125	0.002049	0.000004
Sum	-1.014000	652559.0	23.00000	262.0000	5908.000
SumSq.Dev.	2.009273	3.12E+09	14.73438	43.43750	24679.75
Observations	64	64	64	64	64

**Source:** EViews9.0

#### 4.2 Correlation Analysis

The correlation coefficients of the variable showed that none of the explanatory variables were highly and perfectly correlation. This indicates the absence of multicollinearity existence. However, the results revealed that audit fees(AUDF) and audit committee existence (ACE) depicts a positive and a weak relation with accounting conservatism (ACC). The relation between audit quality (AUDQ), audit report lag(ARL) and accounting conservatism(ACC) is negative and moderate. The result is shown inTable3 below.

**Table3: Correlation Analysis**

	ACC	AUDF	AUDQ	ACE	ARL
Correlation					
t-Statistic					
ACC	1.000000				
	----				
AUDF	0.083913	1.000000			
	0.663068	-----			
AUDQ	-0.053095	0.745743	1.000000		
	-0.418660	8.813710	-----		
ACE	0.078403	0.144211	-0.006176	1.000000	
	0.619253	1.147514	-0.048632	-----	
ARL	-0.126834	-0.063473	0.087579	-0.285763	1.000000
	-1.006822	-0.500795	0.692258	-2.348008	-----

**Source:** EViews9.0

### 4.3 Regression Results and Discussion of Findings

The analysis of the robust regression is used to verify the formulated hypotheses as presented in

Table 4 as shown below.

Table4: Regression Results`

Regressor	Coefficient	Std. Error	z-Statistic	Prob.
C	-0.027672	0.012255	-2.257969	0.0239
AUDF	3.54E-06	3.31E-07	10.67680	0.0000
AUDQ	-0.006792	0.004790	-1.418025	0.1562
ACE	0.009482	0.001916	4.949516	0.0000
ARL	-0.000895	8.02E-05	-11.16666	0.0000
R-squared	0.070379	AdjustedR-squared	0.007353	
Rw-squared	0.101255	AdjustRw-squared	0.101255	
Akaikeinfocriterion	75.14866	Schwarzcriterion	94.96654	
Deviance	0.702617	Scale	0.097328	
Rn-squared statistic	483.5391	Prob(Rn-squared stat.)	0.000000	
Mean dependent var	-0.015844	S.D .dependent var	0.178587	
S.E. of regression	0.183811	Sum squared resid	1.993410	

Dependent Variable: ACC Significant@0.05%

Table4 shows that  $R^2$  value of 0.070379 signifies 7% variation in accounting conservatism which jointly explained by variables of audit fees, audit quality, audit committee existence and audit report lag. The low  $R^2$  implies that non-inclusion of other variables that might contribute to accounting conservatism while the  $Rn^2$  statistics value of 483.53 and its p-value of 0.00 depict a strong and predictable model. It would be revealed that effect of audit fees (AUDF) is positive and significant (z-test=10.67; p=value =0.00). This means that audit fees have a significant positive effect on accounting conservatism (ACC) at 1% level of significant. This implies that increase in audit fees would improve the level of accounting conservatism. The result supports the hypothesis that audit fees have a significant effect on accounting conservatism in Nigeria. The result is not in line with prior studies such as Hamdan, et al. (2012) and Ugbah (2024) that audit fees had insignificant relationship with ACC. The result shows that effect of audit quality (AUDQ) is negative and significant (z-test=-1.41; p=value=0.15). This means that audit quality has no significant and negative effect on accounting conservatism (ACC) at p=value >0.05. The result negates the hypothesis that audit quality has a significant effect on accounting conservatism in Nigeria.

The result is not in line with prior studies such as Abu-Afifa, et al. (2023) and Awuye and Aubert (2022) that audit quality has a significant positive impact on accounting conservatism proxies by earnings management. Table4 also shows that effect of audit committee existence (ACE) is positive and significant ( $z\text{-test}=4.94$ ;  $p\text{-value}=0.00$ ). This indicates that audit committee existence has a significant positive effect on accounting conservatism (ACC) at 1% level of significant. This implies that presence of audit committee existence would improve the level of accounting conservatism. The result supports the hypothesis that audit committee existence has a significant effect on accounting conservatism in Nigeria. The result is in line with prior studies such as ElMahdy, et al. (2020) and Sultana (2015) that frequency of AC meetings had a significant positive relationship with accounting conservatism. It was observed from Table4 that effect of audit report lag (ARL) is negative and significant ( $z\text{-test}=-11.16$ ;  $p\text{-value}=0.00$ ). This indicates that audit report lag has a significant negative effect on accounting conservatism(ACC) at 1% level of significant. This implies that audit report lag would lead to the low level of accounting conservatism. The result supports the hypothesis that audit report lag has a significant effect on accounting conservatism in Nigeria.

### **1. Conclusion**

The study investigated the effect of audit firm mechanism proxies by audit fees, audit quality, audit committee existence and audit report lag on accounting conservatism in Nigeria in the financial reports of 6 active health and pharmaceutical companies listed at Nigerian Exchange Group across eleven years of period from 2012 to 2022. It was concluded from the robust regression results show that audit fees have a significant and positive effect on accounting conservatism at 1% level of significance, audit quality has no significant and negative effect on accounting conservatism, audit committee existence has a significant positive effect on accounting conservatism at 1% level of significance and audit report lag has a significant negative effect on accounting conservatism at 1% level of significance. Based on the study findings, the following recommendations were made:

- (i) The policy makers of health and pharmaceutical companies in Nigeria should motivate the external audit or in terms of audit incentives for purpose of enhancing accounting conservatism.
- (ii) The management should ensure that there is frequency of audit committee meeting so as to improve the level of accounting conservatism.
- (iii) Relevant stakeholders should ensure that there is timely reporting of financial Information in order to cushion negative effect of audit report lag on accounting conservatism

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