

THE EFFECT OF CHANGE IN INCOME CONSERVATISM BASED ON ACCEPTED PRINCIPLES OF ACCOUNTING REPORTS, COST-BENEFIT ANALYSIS

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***Abstract:** Conservatism implies that the costs must be identified earlier and revenues later. In theoretical concepts of accounting, conservatism is recognized as cautious reaction against unreliability aiming at supporting shareholders' equity, so that a higher level of verifiability is required to detect goods news in financial statements to bad news. With regard to given explanations, the present research intends to examine effect of change of accounting conservatism in loss and profit based on accepted accounting principles with analytical reports of loss and profit among the companies listed in Tehran stock exchange during 2008-2013. Results from research indicated that change of accounting conservatism in loss and profit based on accepted accounting principles causes change in incomes from analytical reports of loss and profit, that is, the reflected incomes in financial statements become negative by changing conservatism in loss and profit based on accepted accounting principles. Ultimately, this hypothesis was confirmed that change of accounting conservatism in loss and profit based on accepted accounting principles with analytical reports of loss and profit.*

***Keywords:** Analytical reports, accepted accounting principles.*

INTRODUCTION

Conservatism has been regarded as the tangible *characteristic* of financial reporting, intertwined with accounting practice and theory from the long lost past (Kim B, Jung K. 2007). From point of view of Watts (2003), Conservatism has been regarded as a prominent characteristic in financial reporting and accounting arena since the early 20th century. According to theoretical concepts of financial reporting in Iran, conservatism has been defined in this way: conservatism implies use of a degree of

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care for judgment under conditions undergoing ambiguity, such that the incomes or assets are not proposed more than standard and costs or debts are not proposed less than standard (Abdollah pour and Mohaymeni, 2003). Conservatism has been constantly emphasized by Financial Accounting Standards Committee, having numerous practical applications based on requirements of these standards, e.g. it can mention the factors below: use of *Lower of Cost or Market or Net* realizable value in evaluation of inventories, lack of recognition of goodwill and other intangible assets which have been developed in business unit, *expenditures for research and development*, detecting and reporting expenditures before exploitation as the cost rather than asset and so forth. It should be noted that significant investors and ownership of proprietary rights by them have been regarded as the most important features of emerging capital market. This goes true in Iran. Presence of significant investors including large public organizations and financial institutions in capital market has raised this question whether conservatism can help for representing high-quality financial information which causes efficiency at market and better decision making among users of financial statements and better allocation of capital to companies and industries with higher added value (Hasas Yeganeh, 2010). This research examines *effect of change of accounting conservatism* in loss and profit based on accepted *accounting principles* with analytical reports of loss and profit.

LITERATURE REVIEW

Heflin, Hsu and Jin (2014) conducted a study entitled "Accounting conservatism and street earnings" and provided evidence that conditional conservatism reduces the usefulness of GAAP earnings for valuation by investors. We find that conditional conservatism reduces GAAP earnings persistence and informativeness, makes income smoothing more difficult, and makes forecasting GAAP earnings more difficult for analysts. We also find that analysts forecast Street earnings numbers with less conditional conservatism. The decrease in conditional conservatism from adjusting GAAP earnings to Street earnings leads to improvements in persistence, smoothing, and informativeness and reduces analysts' forecast errors and dispersion. Furthermore, as GAAP conditional conservatism increases, Street earnings more likely differ from GAAP, and the magnitude of the difference between Street and GAAP earnings increases. Finally, we find that exclusions (from GAAP to Street) are of higher quality for firms with higher GAAP conditional conservatism. Our results suggest that, as the conditional conservatism of GAAP earnings increases, analysts' exclusions make Street earnings more useful to investors.

Chi, W. Liu, C.H. and T. Wang. (2011) perceived that there is a positive significant relationship between institutional ownership and conservatism. With regard to findings of research, the companies with lower institutional ownership have lower demand for conservative accounting. Further, they perceived that there is more tendency to conservatism under lack of separation of role of director and board of directors.

Pae, J. (2011) in a study entitled "Unexpected accruals and conditional accounting conservatism" examined the impact of management discretion over accruals on conditional accounting conservatism, defined as the tendency of accountants to recognize bad news on a timelier basis than good news. Prior research suggests that conditional accounting conservatism reflected in earnings is mainly due to the accrual component of earnings, not the cash flow component of earnings. After decomposing total accruals into expected and unexpected accruals, I find that conditional accounting conservatism reflected in accruals is mainly due to unexpected accruals; the negative association between unconditional and conditional accounting conservatism is mainly attributable to unexpected accruals; and (3) firms with higher leverage exhibit conditionally more conservative accounting primarily through unexpected accruals. These results are robust to accrual models that take into account the systematic association between accruals and cash flows and their non-linearity and to the asymmetric persistence of earnings changes specification of conditional accounting conservatism. Taken together, these results suggest that managers exercise their discretion over accruals to expedite the recognition of bad news rather than good news.

RESEARCH METHOD

Quasi-experimental and prospective correlation has been used as the research method at the area of accounting research, categorized as an applied research as it can be used in the process of using information. The statistical population consists of all the companies accepted in Tehran stock exchange during 2009-2013.

Research Hypotheses

- change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in analytical reports of loss and profit.
 - (a) change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in the incomes which must be reflected in financial statements..
 - (b) change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in the costs which must be reflected in financial statements..

RESEARCH VARIABLES

Dependant Variable

Analysis reports: Since the 1980s, a substantial increase has come to realize in number of companies which represent analytical loss and profit reports together with official

loss and profit reports based on accepted accounting principles. Analytical reports differ from the reports based on accepted accounting principles with removal of some of items especially cost items (Bhattacharya, U., Daouk, H., Welker, M., 2003, pp. 641-678). These costs encompass the factors such as the costs for change of structure, changes in goodwill, changes pertaining to ownership, depreciation, interest cost, taxes, *compensation programs* via stock and etc. for instance, if company a purchases stock of company b, this will indicate analytical report of profit for new status in the integrated incomes of both companies before and after acquisition, and this is in contrast to the normal status which increase of income in company is shown. These items are omitted to represent a more associated report. Since there is no standard format on how to represent analytical reports, we might face different reports in an industry. Representation of investment opportunities with a profitability structure is the early aim of analytical reporting which reflects the quality of profit, because loss and profit must have the highest degree of relevance to determine stock price. Yet, a reality lies on this fact that the companies take precaution in differentiation between operating and non-operating activities, which this is considered as the tendencies to smoothen profit (Bowen, G. A. (2005). Analytical reports imply reducing depreciation, interest expense, the costs to change structure, costs of mergers and acquisitions, tax expenses, that is, we do not consider these costs, mentioned that analytical report is called to the acquired profit (Frederickson, J. R., and J. S. Miller. 2004).

INDEPENDENT VARIABLES

Accounting Conservatism in Financial Reporting

There is no agreed-upon universal definition for accounting *conservatism*, yet two major characteristics of conservatism have been examined in accounting texts.

The first characteristic: Downward bias of book value to market value of capital.

The second characteristic: Tendency to proliferation in detecting costs and delaying at recognition of incomes (Shabahang, 2003).

How to measure conservatism can be measured via Basu coefficient or ratio of market value to book value of stock of companies. Basu coefficient refers to a criterion of asymmetric onfirmability of losses and profits (La Fond, R., and R. Watts, 2008). The model designed by Basu (1997) to measure conservatism has been examined from different aspects by the researchers including Ahmed, A. S., B. K. Billings, R. M. Morton and M. Stanford-Harris(2002), Beekes, W, P. Pope and S. Young, (2004), Givoly D., C. Hayn and A. Natarajan, (2007), Lim R., (2006), LaFond, R., and R. Watts, (2008), LaFond R., and S. Roychowdhury, (2007) and Pae, J., (2007). Hence, Basu model(1997) has been used to measure conservatism as follow:

$$NI = \alpha + \beta_1 DR + \beta_2 RET + \beta_3 RET * DR + \varepsilon$$

In model above, indices of company and time have been omitted, that their variables are as follows:

NI: Net interest before unexpected items divided by the market value of equity at the beginning of the financial period.

RD: is a dummy variable, for firms with negative returns equals to one and for other companies equals to zero.

RET: annual return on shares of the company.

In this model, positive return represents good news and negative return represents bad news. Basu model measures the conservatism due to different onfirmability of incomes and costs by applying different sensitivity for the net profit to the returns. In this model, if stock return is positive and adverse of zero, indicates the equation below:

$$NI = \alpha + \beta_2 RET + \varepsilon$$

degree of conservatism that is calculated for each company separately for each year in equation above, β_2 measures sensitivity of profit reaction to good news. If the stock return is negative, there will be equation below:

$$NI = \alpha\beta_1 + (\beta_2 + \beta_3) RET + \varepsilon$$

In equation above, $\beta_2 + \beta_3$ measures sensitivity of profit reaction to the bad news. From point of view of Basu, reaction of profit to bad news is more immediate than reaction of profit to good news, that there will be $\beta_2 + \beta_3 > \beta_2$ and as the result $\beta_3 > 0$. Basu has called β_3 as the asymmetry coefficient of profit, indicating conservatism. Roychowdhury, S., and R. L. Watts, (2007) indicated that when measurement of conservatism via Basu coefficient is estimated in longer time intervals, there will be less error than measurement of this variable using ratio of Market Value of Equity (MVE) to book value, whereby Basu coefficient was adjusted via accumulated multi-period earnings and returns.

CONTROL VARIABLE

Stock Return

Return is called to the benefit and profit which is acquired from an investment. In other words, return can be defined as the change in value of an asset at the end of a period of time to the beginning of that period. Stock return is called to the change in value from change in price in addition to any paid profit (Saeidi and Afkhami, 2012, pp. 65-80). In this research, the return from increase of share value to the first price of period is considered to determine the negative and positive return of companies. To calculate stock return in the companies under study, the factors including increase of capital, the source for increase of capital and the time of capital increase must be considered. To calculate return, the formula below has been used:

State 1.

Increase of capital has not occurred in company.

$$R = \frac{P_1 - P_0 + D}{P_0}$$

In equation above, R , P_1 , P_0 and D represent stock return of company, price of stock market at the end of year, price of stock market in the beginning of year, the cash profit belonged to each share.

State 2.

Increase of capital from saving has occurred in company, under which two states might occur, explained as follows:

a -increase of capital before general assembly, whereby there will be:

$$R = \frac{(1+a)(P_1 + D)P_0}{P_0}$$

In equation above, a represents increase of capital.

b -increase of capital after general assembly.

$$R = \frac{(1+a)P_1 + D - P_0}{P_0}$$

In equation above, a represents increase of capital.

It can be examined before and after assembly in two states.

a -increase of capital from Cash and Receivables before general assembly, that there will be:

$$R = \frac{(1+a)(P_1 + D) - P_0 - a(1000)}{P_0 + a(1000)}$$

b -increase of capital from cash and receivables after general assembly, that there will be:

$$R = \frac{(1+a)P_1 + D - P_0 - a(1000)}{P_0 + a(1000)}$$

State 4.

Increase of capital from cash and receivables, that there will be two states dependant on the increase of capital which has come to realize before or after general assembly:

a -increase of assembly before assembly.

$$R = \frac{(1 + a_1 + a_2)(P_1 + D) - P_0 - a(1000)}{P_0 + a(1000)}$$

a_1 : percent of increase of capital from cash and receivables

a_2 : percent of increase of capital from saving

b -increase of capital after general assembly.

$$R = \frac{(1 + a_1 + a_2)P_1 + D - P_0 + a_1(1000)}{P_0 + a(1000)}$$

RESEARCH MODEL

Multivariate regression model is used for the samples with negative and positive return to test hypotheses:

$$RPLA^1_t = \alpha + \beta_1 RET_t + \beta_2 NI_{t+x} + \beta_3 \Delta NI_{t+x} * RET_t + \beta_4 NI_{t-1+x} + \beta_5 NI_{t-1+x} * RET_t + \varepsilon$$

$RPLA$: analytical reports of loss and profit

RET : stock return

NI : conservatism

HYPOTHESES TESTING

In this section, t -statistics and significance level are used to test hypotheses. If absolute t -value be greater than t -value shown in table, the null hypothesis will be rejected and the considered coefficient will be significant, otherwise it cannot reject null hypothesis. Further, significance level indicates minimum probability for confirming null hypothesis based on the considered coefficient when equaled to zero, that it cannot reject null hypothesis if this probability be greater than 5%, otherwise the considered coefficient will be significant.

With regard to the size of the data of the companies under study, this hypothesis is tested for a period of time during 3 years. During these three years, accumulated profit and return during 3 years are calculated. Then, calculated mean of variables in 2011, 2012 and 2013 is used.

Testing the First Hypothesis

Multivariate regression model below is used for the samples with negative and positive return separately to test hypotheses a and b :

$$RPLA^2_t = \alpha + \beta_1 RET_t + \beta_2 \Delta NI_{t+x} + \beta_3 \Delta NI_{t+x} * RET_t + \alpha_4 NI_{t-1+x} + \beta_5 NI_{t-1+x} * RET_t + \varepsilon$$

$RPLA$: loss and profit analytical reports

RET: stock return

NI: conservatism

The model for testing hypothesis a for the companies with positive return

$$RPLA_t = \alpha + \beta_1 RET_t + \beta_2 \Delta NI_{t+x} + \beta_3 \Delta Incom_{t+x} + \beta_4 \Delta NI_{t+x} * RET_t + \beta_5 NI_{t-1+x} + \beta_6 NI_{t-1+x} * RET_t + \varepsilon$$

The model for testing hypothesis a for the companies with negative return

$$RPLA_t = \alpha + \beta_1 RET_t + \beta_2 \Delta NI_{t+x} + \beta_3 \Delta Cost_{t+x} + \beta_4 \Delta NI_{t+x} * RET_t + \beta_5 NI_{t-1+x} + \beta_6 NI_{t-1+x} * RET_t + \varepsilon$$

Hypotheses *a* and *b* imply that if change of conservatism in loss and profit based on accepted accounting principles is positive, less income and more cost will be reflected in financial statements, as a result analytical loss and profit reports will reduce; yet if change of conservatism in loss and profit based on accepted accounting principles is negative, more income and less cost will be reflected in financial statements, as a result analytical loss and profit reports will increase. With regard to given explanations, it is predicted that $\hat{\alpha}_3$ is negative and significant for the sample with positive return and positive and significant for the sample with negative return.

Results of Hypothesis Testing

In this research, the second hypothesis has two secondary hypotheses that the results from testing each of hypotheses have been represented in following. To test hypothesis *a*, the regression model above has been used for the sample with positive return. As shown in table below, β_3 for the periods -1, 0 and 1 equals to -2.91, -0.66 and -0.982, and *t*-value equals to -3.82, -1.85 and -2.18 and sig equals to 0.00, 0.04 and 0.05, as the result this hypothesis for the periods -1, 0 and 1 is accepted at confidence level 99%, 95% and 95%, respectively.

To test hypothesis *b*, the regression model above has been used for the sample with negative return. As shown in table below, β_3 for the periods -1, 0 and 1 equals to 0.54, 0.85 and 1.54, and *t*-value equals to 2.66, 2.32 and 3.62 and sig equals to 0.04, 0.03 and 0.001, as the result this hypothesis for the periods -1, 0 and 1 is accepted at confidence level 99%, 95% and 95%, respectively.

CONCLUSION

High conservatism in representing financial statements causes the investors and analysts take action to predict financial status of company and profitability capability based on real and/or expected conditions. In this regards, the official financial statements might have less reliability for the investors and numerous analytical reports might emerge as contributing factor in stock prices. Hence, despite diverse analyses which are against official predictions, a majority of investors are confused in detecting stock with more reliable information, because on one hand, companies are accused of hiding profit and representing poor reports and investors are persuaded to purchase

Table 1
Results of Testing Hypothesis a for the Sample with Positive Return

Variables	X = -1				X = 0				X = 1				
	Sign	Coefficients	t-statistics	Sig	Coefficients	t-statistics	Sig	Coefficients	t-statistics	Sig	Coefficients	t-statistics	Sig
$RPLA_t = \alpha + \beta_1 RET_t + \beta_2 \Delta NI_{t+x} + \beta_3 \Delta Incom_{t+x} + \alpha_4 \Delta NI_{t+x} * RET_t + \beta_5 NI_{t-1+x} + \beta_6 NI_{t-1+x} * RET_t + \varepsilon$													
A													
$\beta_1 RET_t$		0.41	3.08	0.00		1.89	0.55		1.02	0.09		1.02	0.09
$\beta_2 \Delta NI_{t+x}$		0.99	1.81	0.001		4.81	1.11		2.28	0.21		2.28	0.21
$\beta_3 \Delta NI_{t+x} * RET_t$		2.91-	3.82-	0.00		0.75	0.15		1.19	0.25		1.19	0.25
$\beta_4 NI_{t-1+x}$		0.04	0.19	0.91		1.85-	0.04		2.18-	0.05		2.18-	0.05
$\beta_5 NI_{t-1+x} * RET_t$		1.11-	1.09	1.09		2.21	0.07		1.33	0.16		1.33	0.16
Determination coefficient			0.54			2.46-	0.02		1.99-	0.39		1.99-	0.39
Adjusted determination coefficient			0.42			0.41			0.35			0.35	
Durbin-Watson			1.91			0.28			0.09			0.09	
F-value			4.12			1.87			1.81			1.81	
Sig of F-value			0.02			3.11			2.71			2.71	
						0.05			0.39			0.39	

Table 2
Results of testing hypothesis b for the sample with negative return

Variables	X = -1				X = 0				X = 1				
	Sign	Coefficients	t-statistics	Sig	Coefficients	t-statistics	Sig	Coefficients	t-statistics	Sig	Coefficients	t-statistics	Sig
$RPLA_t = \alpha + \beta_1 RET_t + \beta_2 \Delta NI_{t+x} + \beta_3 \Delta Incom_{t+x} + \alpha_4 \Delta NI_{t+x} * RET_t + \beta_5 NI_{t-1+x} + \beta_6 NI_{t-1+x} * RET_t + \varepsilon$													
A													
$\beta_1 RET_t$		0.67-	1.86	0.05		4.11	0.01		4.81	0.04		4.81	0.04
$\beta_2 \Delta NI_{t+x}$		0.45	2.05	0.001		1.62	1.06		0.64	0.45		0.64	0.45
$\beta_3 \Delta NI_{t+x} * RET_t$		0.54	2.66	0.04		2.59	0.01		0.51	0.83		0.51	0.83
$\beta_4 NI_{t-1+x}$		0.87	3.05	0.00		2.32	0.03		3.62	0.001		3.62	0.001
$\beta_5 NI_{t-1+x} * RET_t$		0.91	2.35	0.04		1.02	0.52		1.92-	0.91		1.92-	0.91
Determination coefficient			0.32			1.32	0.41		2.85-	0.00		2.85-	0.00
Adjusted determination coefficient			0.21			0.25			0.41			0.41	
Durbin-Watson			1.82			0.12			0.26			0.26	
F-value			3.84			1.99			1.96			1.96	
Sig of F-value			0.04			2.15			3.02			3.02	
						0.05			0.02			0.02	

stock of companies, and on the other hand the companies are often accused due to incompliance with principles of conservatism. In this state, investors know official reports of companies unreliable and negative adjustment of loss and return to more realistic poor states unreliable. Hence, the question remains however, whether official reports of companies are the most suitable sources for analysis to achieve a reliable return and whether it can achieve them via analytical reports through removal of special items?;with regard to given explanations, this section analyzes summary of results.

Change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in analytical loss and profit reports.

a–change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in the incomes which must be reflected in financial statements.

With regard to the statistical analyses, it must state that β_3 for the periods -1, 0 and 1 equals to -2.91, -0.66 and -0.982, and *t*-value equals to -3.82, -1.85 and -2.18 and sig equals to 0.00, 0.04 and 0.05, as the result this hypothesis for the periods -1, 0 and 1 is accepted at confidence level 99%, 95% and 95%, respectively. This implies that hypothesis *a* which says change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in the incomes which must be reflected in financial statements, is confirmed.

On the other hand, β_3 for the periods -1, 0 and 1 equals to 0.54, 0.85 and 1.54, and *t*-value equals to 2.66, 2.32 and 3.62 and sig equals to 0.04, 0.03 and 0.001, as the result this hypothesis for the periods -1, 0 and 1 is accepted at confidence level 99%, 95% and 95%, respectively. This implies that hypothesis *b* which says change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in the costs which must be reflected in financial statements, is confirmed.

Ultimately, it must say that the second hypothesis was confirmed based on hypotheses *a* and *b*, specified that change of accounting conservatism in loss and profit based on accepted accounting principles brings about change in analytical loss and profit reports. As said above, with regard to size of data, this hypothesis was measured for a period during three years 2011, 2012 and 2013. With regard to the explanations for previous hypothesis, it must state that incomes appear negative for three years, costs appear positive for two years and negative for one year under increase of conservatism in loss and profit based on accepted accounting principles. On the other hand, these changes in official financial statements result in change of analytical loss and profit reports proposed for the investors. Indeed, this hypothesis seeks to show to which extent change of conditions in companies from ambiguity to confidence can bring about difference in analytical loss and profit reports. This can be inferred in this

way that incomes reduce and cost increase by applying more conservatism in measuring the profits, under which the stock return is influenced, because users of financial statements respect conservative accounting information, because such information cause reduction in the costs due to information asymmetry among investors. Under these conditions, analytical reports which seek to represent investment opportunities with a suitable profitability structure face this event that change of conservatism in official loss and profit reports has been influenced, resulting in reduction of incomes and increase of costs and obliging to modify analytical reports for the investors, because investors respect conservative accounting information which this reduces information asymmetry.

Notes

1. Reports, Profit and Loss analysis
2. Reports, Profit and Loss analysis

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