

THE EFFECT OF ACCOUNTING CONSERVATISM ON THE VALUE RELEVANCE OF ACCOUNTING INFORMATION: EVIDENCE FROM INDONESIA

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ABSTRACT

The purpose of this study is to examine the effect of accounting conservatism on the value relevance of accounting information. This research utilize the associative quantitative approach. The sample consists of 111 listed companies in Indonesia, observed over 11 years, with a total of 1221 observations. The data analysis technique used to examine the hypothesis in this study is the one-way anova test. The hypothesis test result shows that the hypothesis is rejected, and concludes that value relevance of earnings and book value is not significantly influenced by the degree of accounting conservatism applied. This is seen from the insignificant difference in value relevance among the low, moderate and high conservatism group. Reviewing the data obtained, the rejection of the hypothesis may be due to the frequent lateness of financial statement publication and the low sophistication of investors in utilizing the accounting information in the decision-making process.

Keywords: *Accounting Conservatism, Value relevance, Capital market*

1. Introduction

This study is a market-based accounting study which assesses investors' appreciation on the accounting information in the financial statements provided by companies in Indonesia. If the information provided are largely used by investors to determine their investment decisions, the accounting information is considered to have high value relevance. Among the factors which affects investor's appreciation on the information provided in financial statements, conservatism is seen as a factor which could have considerable effects. This is because, despite being considered as a divergence from neutrality, accounting conservatism could still benefit stockholders. This study is motivated by the removal of prudence (hence conservatism) from the financial information characteristics in SFAC No. 8. Even though Indonesia has never directly adopted the concepts published by FASB (publisher of the SFACs), SFAC No. 8 is a collaboration between FASB and IASB (International Accounting Standards Board), while IASB is the standard setting body that publishes the IFRS (International Financial Reporting Standards) which is adopted in Indonesia. Thus, this study attempts to examine the effects of accounting conservatism on the value relevance of accounting information. This study is also to provide recommendations on whether the accounting standards regulator in Indonesia should apply the removal of conservatism or sustain it.

Related to the benefits of conservatism, it was explained in SFAC No. 8, BC3.28 that:

“Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic”.

The desirable effect of accounting conservatism in this statement is in line with the explanation by Sterling (1967), which was quoted in the research by Balachandran and Mohanram (2010). They explained that in the face of a universal inclination to overstate and to reduce overstatement, understatement (conservative accounting practice) is proposed with the hope of striking a balance. This shows that despite the removal from the financial statement characteristics in SFAC No. 8, conservative accounting practices are still beneficial to dampen management estimates that could be too optimistic and estimates that are sometimes to favor the management's individual incentives. Hence, producing financial statements with less management's opportunistic discretions by requiring a greater level of verifiability in recognizing gains. In line with the desired benefit of conservatism, conservative accounting practice in this research is defined as follows: accounting is conservative and prudent if, as a result of requiring higher verification of economic gains and losses, there will be less managerial opportunistic discretions in the financial statement.

Among the reasons conservatism and prudence are omitted from SFAC no. 8 is that conservatism is not compatible with neutrality (Mora and Walker, 2015). In SFAC no. 8 QC14, a neutral depiction is defined as the presentation of financial information without any bias, meaning that financial statements should not report information that are slanted, weighted, emphasized nor deemphasized. Conservatism here may be viewed as a divergence from neutrality. However, in previous studies, (Kousenidis, 2009; Wendt, 2010; Sari, 2014) conservatism is seen to be preferred by investors. Various organizations have also shown great concerns regarding the omission of conservatism in SFAC no. 8, such as by the UK Shareholders Association in 2013. This may imply that the value relevance of accounting information would be higher for a higher degree of conservatism applied. Thus, despite the divergence of information from neutrality, there are a large number of investors who seem to prefer a more conservatively reported accounting information, and this preference can be explained using the uncertainty reduction theory (Redmond, 2015).

Under the condition of uncertainty, whether the agents truly do maximize principals' interest or prioritize their own incentives, in which the latter is more likely, especially because agents have more information regarding the company than principals, investors or principals would prefer to minimize these uncertainties. This trait or behavior of preferring less uncertainty by investors can be explained by the uncertainty reduction theory. Berger and Calabrese (1975) in Redmond (2015) defined uncertainty as having a number of possible alternative predictions or explanations, which in this case is the uncertainty of management's intention to provide faithfully representative financial information to the principals. It is then justifiable that investors may want to prefer more conservatively reported accounting information in order to reduce this uncertainty, despite the view that conservatism is a divergence from neutrality.

2. Literature Review And Hypothesis Development

2.1 Accounting Conservatism

Basu (1997) stated that accounting conservatism can be interpreted as capturing accountants tendency to require a higher degree of verification in recognizing good news (gains) than for bad news (losses) in the financial statement. More timely recognition of bad news (losses) in relation to good news (gains) is a sign of conservatism and many models to measure accounting conservatism are based upon this principle. Nobes (2008) defined accounting conservatism as the tendency to understate profit and assets.

Ball et al. (2011) stated that conservatism is the speed with which losses are reported. The timely recognition of loss in accounting conservatism is implemented with the justification that highly verified information would produce greater quality financial statement for users in making economical decisions. Manuel (2009) argued in terms of contracts, there are opportunistic incentives for managers to overstate assets and income in order to influence contracts based on accounting numbers. This opportunistic behavior can be counteracted by conservatism, minimizing the expected losses to investors using the asymmetric loss functions (Watts, 2003). Meaning that conservatism is able to dampen the opportunistic behavior and tendencies of managers as they must make timely recognition of losses compared to gains.

2.2 Value Relevance of Accounting Information

Value relevance can be defined as the usefulness of accounting information from the perspective of equity investors (Beisland, 2008). Brown et al. (2006) defined value relevance of earnings as "the degree to which accounting earnings summarize information impounded in market prices". Consistent with the views above, value relevance is justified to be a capital market based research method which measures the usefulness of accounting information by assessing investors appreciation towards the information provided by the financial statement in making economical decisions.

Beisland defined value relevance as the ability of financial information to capture and/or summarize information that determines firm value. Thus, value relevance is measured as the degree of statistical association between accounting information and market values or returns.

Holthausen and Watts (2001) stated that value relevance tests effectively provide information to us regarding how equity investors valuation is affected by accounting information, such as book value and earnings. Earnings and book value are commonly used tools in value relevance research in which earnings inform the profitability of the stocks based on revenues and expenses in a certain period, while book value pictures the net value of assets, and this value indicates growth potential as well as the debt magnitude (as $\text{net assets} = \text{assets} - \text{liabilities}$) of a company.

2.3 Accounting Conservatism on the Value Relevance of Accounting Information

Stock market accounting researchers have given critics to the value relevance of accounting information and a number of studies have created the impression that accounting numbers have lost their value relevance. On the other hand, conservatism has been sustained in accounting for many years. Conservatism simply states that in recording financial events, accountants should “anticipate no profit but anticipate all losses” (Watts, 2003). Conservatism imposes a high threshold of verifiability and provides information that is useful for many purposes. Conservative accounting dictates that there must be verifiability which minimizes the potential for errors in measurement, and correspondingly increases the reliability of the resulting information. If unverified information is sufficiently unreliable, the relevance of that information may well be diminished (Felix and Rebecca, 2015). Thus, as accounting practices become more conservative, investors would be benefitted by receiving verified information, which in turn would increase the usefulness, hence value relevance of accounting information.

Based on the discussions above, the formulated hypothesis is as follows:

H1: The value relevance of accounting information of companies with more conservative accounting practices is higher than companies with less conservative accounting practices.

3. Research Methodology

3.1 Research Design and Location

This study utilize an associative quantitative design in order to discuss and examine the relationship between the degree of accounting conservatism and the value relevance of accounting information. The research location is in Indonesia and takes place in the Indonesia Stock Exchange (IDX) as the research is conducted on listed companies in the IDX. Both variables utilize information attained from the stock market and financial reports of listed firms in the IDX.

3.2 Population, Sample and Sampling Method

The population in this research are the companies that are still listed in the IDX from 2006 – 2016. The study uses the starting year of 2006 with the considerations that the General Guidelines for Good Corporate Governance Indonesia was finalized and published by KNKG (National Committee of Governance Policy). With this guideline being published, there are greater tendencies for investors to utilize the financial statements in making decisions and the market response will better reflect the influence of conservatism on the value relevance of accounting information. Purposive sampling is used to determine the samples in this research. Purposive sampling is conducted by using certain criteria, determined with the help and consideration of expert experience to obtain samples that are more relevant to the research purpose. The criteria of the samples are:

- a. Companies that are still listed in the IDX from 2006 – 2016.
- b. Companies selected are non-financial institutions, as this industry has specific regulations that are different from other industries. Inclusion of the financial industry may result in bias results, hence the need to control for industrial effect.
- c. Companies that publish sufficient information for the research.
- d. Use IDR (Indonesian Rupiah) as the reporting currency in order to increase uniformity.
- e. Exclude firms with negative value relevance values (Collins, D.W., Pincus, M., and Hong Xie, 1999)

Afterwards, the sample size is determined using Slovin's Formula and the companies are selected using the simple random sampling technique. The sample size in this research based on the purposive sampling method and the Slovin formula is 111 companies, with a total of 1221 observations.

3.3 Data Type, Source and Collection Method

In this study, the data type is quantitative data and the data source is secondary data which are obtained from the financial statements published by companies. Data collection in this research is conducted using the non participant observation method. Data is collected from the financial statements in the period of 2006 – 2016 published by listed companies in Indonesian Stock Exchange.

3.4 Operational Definition of Variables

3.4.1 Value relevance of accounting information

As distinguished by Holthausen and Watts (2001), the combined model (regression model of price on earnings and book value) is used to measure the magnitude of value relevance of accounting information, by determining the coefficient of determination (R^2) of the regression. This method is also used in prior studies, (Collins et al., 1997; Lev et al., 1999; Kousenidis, 2009; Balachandran and Mohanram, 2010; Wendt, 2010; Zacharias, 2015). To avoid bias, in line with the research conducted by Brown et al. (1999), the regression model is deflated by lagged price. The model to measure value relevance is shown as follows:

$$\frac{P_{i,t}}{P_{i,t-1}} = \alpha_0 + \alpha_1 \frac{EPS_{i,t}}{P_{i,t-1}} + \alpha_2 \frac{BVPS_{i,t}}{P_{i,t-1}} + \varepsilon_{i,t}$$

Where,

$P_{i,t}$: share price of firm i on the publication date for financial period t

$EPS_{i,t}$: accounting earnings per share of firm i during year t

$BVPS_{i,t}$: book value per share of firm i at the end of year t

$\varepsilon_{i,t}$: other value-relevant information of firm i for year t

α_1, α_2 : Coefficients

α_0 : Constant

Hence, in this study, value relevance of accounting information is represented by the coefficient of determination R^2 , by regressing stock price (on the publication date of the financial statement) on EPS and BVPS for each company over a period of time (2006-2016), deflated by lagged price, to avoid problems associated with variables expressed in levels (Kousenidis, 2009).

3.4.2 Accounting conservatism

Through identification of the measurements of accounting conservatism, two types of proxy were found, namely market-based measurement and accrual-based measurement. As the measurement of value relevance already utilized the price to earnings and book value regression model based on Ohlson's model which is a market mechanism measurement, the accrual-based measurement is used to examine the degree of conservatism applied by companies.

Givoly and Hayn's (2000) Discretionary Accrual Model as proxy of accounting conservatism, has been commonly used in previous studies (Ahmen et al., 2002; Seswanto, 2012; Mohammadi et al., 2013; Mahjour et al., 2015). Givoly and Hayn argued that conservative accounting leads to persistently negative accruals. Consistent with this explanation, the discretionary accrual model shown below is used in this research.

$$\text{ACC}_{it} = (\text{NI}_{it} + \text{DEP}_{it}) - \text{CFO}_{it} \quad \text{Model (1)}$$

$$\text{OACC}_{it} = \Delta(\text{AR}_{it} + \text{I}_{it} + \text{PE}_{it}) - \Delta(\text{AP}_{it} + \text{TP}_{it}) \quad \text{Model (2)}$$

$$\text{NOACC}_{it} = (\text{ACC}_{it} - \text{OACC}_{it}) \quad \text{Model (3)}$$

For the variables in the first model, ACC is the total accruals, NI is the net income, DEP is the depreciation expense and CFO is the operating cash flows. In the second model, OACC is the operating accruals (nondiscretionary), AR is the accounts receivable, I is inventory, PE is the prepaid expenses, AP is the accounts payable and TP is the taxes payable. Finally, the third model includes NOACC which is the non-operating accruals, in other words, discretionary accruals. To measure conservatism, the NOACC is deflated by the total assets of the company in each time period, and afterwards multiplied by (-1). The value resulted measures the degree of conservatism in company *i* during time period of *t* (CON_{it}).

After calculating the degree of conservatism of each individual company, the companies will be divided into three groups. The companies are distributed according to their average accounting conservatism level. The groups are: low conservatism, moderate conservatism, and high conservatism. Groupings are done by taking the top and bottom 30 percent for low and high conservatism, and the middle 40 percent for the moderate conservatism (Balachandran et al., 2010). With this, companies are distributed into 3 groups based on their average accounting conservatism level over the 11 years period (2006 – 2016).

3.5 Data Analysis Technique

The method to analyze the data in this study is the one-way anova (analysis on variance). The analysis tool utilized is the Statistical Packages for Social Sciences (SPSS) for Windows. To examine which group has the highest value relevance, the mean value of each group are viewed. To determine whether the relationship between the variables are significant, the significance value of the anova test and of the post-hoc test (conducted only if the anova test shows a p-value of <0,05) are used. If the p-value from the anova test is lower than the significance level of 0,05, it can be said that there is a significant difference(s) between the value relevance of two or more conservatism group. The anova test result also shows the mean and standard deviation of each independent variable group tested. This would show the average value relevance of accounting information for each conservatism level group.

Afterwards, further analysis on the influence of accounting conservatism on value relevance of accounting information is done by using a Post-Hoc Test. The anova test shows whether there exist a significant difference among the groups tested, however it does not show which groups are significantly different. Therefore, the Post-Hoc Test is used to examine these details. The type of Post-hoc test utilized depends on the homogeneity of variance test. Two groups are concluded to be significantly different if the P-value resulted from the post hoc test is lower than 0,05. Conclusions can be made based on the anova test result and the mean values of value relevance of the groups. The mean values show which group has higher or lower value relevance and the Post Hoc Test shows whether the difference is significant to conclude how value relevance is influenced by conservatism and whether this influence is significant or not.

4. Data Analysis

4.1 General Characteristics of Sample

This study is conducted on all listed companies in the Indonesia Stock Exchange (IDX) over the period of 2006-2016. The researcher observes all listed companies in IDX in order to obtain results regarding the Indonesian capital market in general. Indonesia Stock Exchange consists of 9 industry sectors, namely: 1. Agricultural, 2. Mining, 3. Basic and Chemical Industries, 4. Miscellaneous Industries, 5. Industrial of Consumer Goods, 6. Properties, Real Estate and Building Construction, 7. Infrastructure, Utilities and Transportation, 8. Finance, 9 Trade, Services and Investment. However, the companies from the Financial Industry are excluded from the sample to avoid large industrial effects due to the characteristics of this industry that has different value relevance with high intangible assets and liabilities (Asthana and Chen, 2007) and different regulations which the financial industry must comply to.

4.2 Normality Test

Before the anova test, the normality test must be conducted to examine whether the value relevance of companies in each conservatism group is normally distributed or not. The Kolmogorov-Smirnov test is utilized in this study. The residuals are normally distributed if the P-value is greater than 0,05. The normality test result is shown in table 1.

Table 1. The Result of the Normality Test

Conservatism Group	Kolmogorov-Smirnov		
	Statistic	df	Sig.
Low	0,080	33	0,200
Moderate	0,164	45	0,004
High	0,147	33	0,067

Source: *computed data, 2018*

Based on the results of the normality test in table 1, the low conservatism and high conservatism are known to have significance values of 0,200 and 0,067 respectively. This shows that the value relevance data in the low conservatism group and the high conservatism group are normally distributed. Meanwhile, the moderate conservatism group has a significance value of 0,004 which means that the value relevance data in this group are not normally distributed. However, the one-way anova test is able to provide fairly accurate results despite violations of the normality assumption (Oestertagova & Ostertag, 2013). Thus, the anova test is still applicable to test the hypothesis.

4.3 Homogeneity of Variance Test

The homogeneity of variance test is conducted to test whether the residuals of the three groups have homogenous variances. According to Oestertagova and Ostertag (2013), the analysis on variance assumes that different population has the same variance. Thus, this test is used to determine whether the data fulfills the above mentioned assumption. In this study, the Levene's test is used to determine the homogeneity of variances. If the P-value or in other words the significance value of the Levene's test is greater than 0,05 ($>0,05$), there are equal variances among the different groups. The result of the homogeneity of variance test is shown in the table 2.

Table 2. The Result of the Homogeneity of Variance Test

Levene Statistic	df1	df2	Sig.
1.930	2	108	0.150

Source: *computed data, 2018*

Based on Table 2, the result of the Levene's test exhibit a P-value or significance value of 0.355 > 0.05. Thus, it can be concluded that the data groups in this research have homogenous variances and the one-way anova test is applicable to examine the hypothesis of this study.

4.4 Hypothesis Test Utilizing the Anova Test

In this study, the value relevance of accounting information (R^2) from different sample groups (Low Conservatism, Moderate Conservatism, and High Conservatism) are compared. The analysis on variance (ANOVA) is a statistical procedure concerned with comparing means of several samples and it can be considered as an extension of the t-test from two independent samples to more than two groups (Oestertagova and Ostertag, 2013). In table 3, the group descriptive statistics are shown as follows.

Table 3. The Group Descriptive Statistics

	Conservatism	N	Mean	Std. Deviation	Std. Error
Value Relevance	Low	33	0.461	0.241	0.042
	Moderate	45	0.435	0.287	0.043
	High	33	0.353	0.248	0.043
	Total	111	0.419	0.264	0.025

Source: *computed data, 2018*

Based on table 3, the value relevance mean of the low conservatism group is the highest, followed by moderate conservatism, and lastly high conservatism. This is seen from the mean value relevance of each group in which low conservatism group has a mean value relevance of 0.461, for moderate conservatism it is 0.435, and for high conservatism group it is 0.353.

In table 4, the result of the Anova test is displayed as follows.

Table 4. The Result of the One-Way Anova Test

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	0.214	2	0.107	1.555	0.216
Within Groups	7.448	108	0.069		
Total	7.663	110			

Source: *computed data, 2018*

The results in table 4.6 shows that the P-value of the anova test is 0.216 which is greater than 0.05. This means that the differences in value relevance among the conservatism groups are insignificant. As the Anova test shows a P-value greater than 0.05, no post-hoc test is conducted. With this result, accounting conservatism can be said to have insignificant influence on the value relevance of accounting information.

4.5 Additional Tests to Examine the Relationship Between Variables

To further examine the relationship between accounting conservatism and value relevance of accounting information, the possibility that the price of each stock was not significantly influenced by the accounting information such as earnings and book value is taken into consideration. If this is true, the analysis results may not produce accurate results. In the attempt to consider this possibility, the significance value of each regression to calculate a firm's value relevance is reassessed. If the significance value resulted from the regression is greater than 0.05, the company is excluded from the initial sample. This is because by statistical definition, if the significance value is greater than 0.05, earnings and book value do not affect the price, which means that in making decisions related to the stock market, the accounting information is not significantly utilized. As the purpose of this study is to review the effect of accounting conservatism on the value relevance of accounting information, removing the sample with a significance value of greater than 0.05 may result in a more accurate result. After filtering, the total remaining sample is 53 companies. This amount is less than a half of the initial sample. This indicates that there might be many noise traders or low sophistication of investors in utilizing the accounting information provided in the financial statement to make investment decisions.

The 53 samples are then divided into two groups (More Conservative and Less Conservative) and are analyzed using the independent sample T-test. However, the conclusion of the results remain unchanged (results displayed in appendix 1). There is no significant difference between the two conservatism level groups.

5. Research Findings And Discussions

5.1 The Effect of Accounting Conservatism on the Value Relevance of Accounting Information

The hypothesis (H_1) in this study, which states that the value relevance of firms with higher degree of accounting conservatism is greater than the value relevance of firms with lower degree of conservatism, is rejected. This is seen from the One-way Anova test result in Table 4 which shows that the P-value is 0.216 or 21.6% and the mean value relevance is highest for the low conservatism group (0.461), followed by the group of moderate conservatism (0.435) and lowest for the high conservatism group (0.353). With the anova test result showing a P-value of 0.216, this study provides empirical evidence showing that the degree of accounting conservatism does not significantly influence the value relevance of accounting information, namely the earnings and book value, of listed firms in Indonesia. Hence, H_1 is rejected, which means that the value relevance of accounting information of firms in Indonesia are not significantly influenced by the accounting conservatism practices applied by the companies.

The result of this study is in line with the result attained by Balachandran and Mohanram (2010). Balachandran and Mohanram stated that they did not find any evidence that increasing conservatism entails lower value relevance, however they also stated that the decline in value relevance is relatively the same for groups with increasing conservatism and groups with steady conservatism. Along with the result of this research, it can be inferred that conservatism does not significantly influence the value relevance of accounting information.

From the data collected in this study, it was also found that, in average, companies are late 46.4% of the time. This lateness is believed to decrease the relevance, hence value relevance of accounting information. This could be among the reasons why the hypothesis was rejected despite the usefulness of conservatism for investors. Another limitation found is that more than half of the companies from the total sample of this research have a p-value of the regression of their stock price on earnings and book value above 0.05. This could mean that in making decisions, many investors do not use the accounting information available.

6. Research Implication

The research result has theoretical and practical implications. To the best of our knowledge, this is the first study of the influence of conservatism on the value relevance of accounting information which incorporates all the sectors of listed companies in the Indonesian Stock Exchange over the years of 2006-2016, except for the financial sector which is to minimize the industrial effect on the research result. As it incorporates almost all of the sectors of listed companies in Indonesia, the results of this study is able to be used for generalization purpose for companies in Indonesia. This study provides evidence that accounting conservatism does not have significant influence on the value relevance of accounting information.

The practical implication of this research is that accounting standards setters or regulators in Indonesia should consider implementing the concepts in SFAC no. 8 regarding accounting conservatism as conservatism is not deemed to increase the value relevance of accounting information. With the usefulness of financial statement being insignificantly affected by accounting conservatism, regulators may consider to regulate accounting practices towards less conservatism in which has been viewed as a divergence from neutrality. Likewise, it is also advisable for companies to strive more towards neutrality, and less towards conservative accounting practices.

7. Research Limitations

The limitation of this research is the scope in which only includes listed companies in the Indonesian Stock Exchange. This means that the results may not be applicable in other countries with different accounting regulations and developments, especially for countries with a large difference in sophistication level of accounting information users. More data can be added, by expanding the observation period or use the quarter reports, to attain a more accurate magnitude of the value relevance for each company. This study also did not consider the punctuality of publication which may influence the relevance of accounting information to investors, hence influence the value relevance. Under similar conditions such as in Indonesia (punctuality and sophistication level), future studies are advised to include the above mentioned considerations in their model.

8. Conclusion

According to the hypothesis test results, it can be concluded that accounting conservatism does not have significant effect on the value relevance of accounting information in Indonesia. No significant differences in explanatory power of the accounting information such as earnings and book value were observed among the highly conservative, moderately conservative and less conservative group of firms. This can be interpreted as accounting conservatism applied by companies listed in the IDX is not a significant determinant for investors in the process of making investment decisions.

Accounting conservatism may have its benefits, but it may also reduce relevance as it occasionally ignores certain information relevant to stock prices. Hence, it is advisable for the accounting standards regulator in Indonesia to consider less conservatism and strive more towards neutrality of accounting information.

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Appendix 1

Independent Sample T-Test Result after Further Filtering

Independent Samples Test

		Levene's Test for Equality of Variances		t-test for Equality of Means						
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
									Lower	Upper
Value_Relevance	Equal variances assumed	.080	.778	-.639	51	.526	-.02945	.04611	-.12201	.06311
	Equal variances not assumed			-.638	50.704	.526	-.02945	.04614	-.12209	.06319