

## THE EFFECT OF ACCOUNTING CONSERVATISM THROUGH CORPORATE GOVERNANCE ON EARNING QUALITY

Tumpal Manik (tmanik.umrah.ac.id or tmanyk@yahoo.com)  
University of Maritime Raja Ali Haji

### ABSTRACT

The purpose research is to examine the effect of accounting conservatism through corporate governance mechanisms on earning quality at manufacture companies listed on the Stock Exchange of Indonesian from year 2014 to 2016. The sampling was done by purposive sampling method for 168 companies, meet the criteria a total 91 companies, total data of research 273. The data were analyzed using regression method and testing by statistic software. Results Obtained from testing the first hypothesis; the effect of accounting conservatism on earning quality showed significant results, the effect of 23,3%. Second hypothesis; accounting conservatism with accrual sizes effect on earnings quality showed significant results, the effect of 24,3%. The third hypothesis; accounting conservatism with market value effect effect on earnings quality on earnings quality showed significant results, the effect of 27,1%. This means that management positively signals the application of accounting conservatism within the company and has an impact on improving the quality of earnings. The finally showed that accounting conservatism through corporate governance mechanisms that are more effective in restraining accounting manipulation can better exploit the benefits of conservatism and simultaneously curtail its costs, leading to a positive relation between the strength of reporting oversight and conservative accounting.

Keywords: Accounting Conservatism, corporate governance, earnings quality

### 1. INTRODUCTION

Accounting conservatism has become a more common feature of financial accounting practice, Even though conservatism has influenced accounting practices for centuries (Basu 1997), there remain heated debates whether it is a desirable property of accounting. The Advocates argue that conservatism helps improve contracting efficiency (e.g., Basu 1997; Watts 2003a and 2003b; Ball and Shivakumar 2005), reduce information asymmetry (e.g., LaFond and Watts 2008) and lower the cost of capital (e.g., Ahmed, Billings, Morton and Stanford-Harris 2002; García Lara, Osma and Penalva 2011).

Opponents of conservatism, on the other hand, contest that it distorts accounting data (Hendriksen and Van Breda 1992) and even decreases the efficiency of contracts (e.g., Gigler, Kanodia, Sapa and Venugopalan 2009; Li 2013). This is so as, given that conservatism defers the recognition of gains and constrains the overstatement of earnings and assets, under conservative accounting managers will find it more difficult to opportunistically increase earnings to avoid breaking debt covenants, avoid missing earnings targets or increase their compensation.

Conservatism is an important and basic principle in financial accounting. It stipulates that possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets. The continuing influence of conservatism on financial reporting makes it likely that this phenomenon is beneficial to economic agents who prepare, use and rely on financial statements (Bushman & Piotroski, 2006).

Managers take accounting and real decisions with the intent to mislead firm stakeholders about the underlying economic performance of the firm. This earnings management reduces the precision of the earnings signal, increasing outsiders' uncertainty (Rajgopal, 2011), as well as potentially leading to information asymmetries among firm insiders and to decreases in investment efficiency. Earnings management not only conceals the company actual performance, but it also masks underlying trends in revenue and earnings growth, which help to build expectations of future growth and product demand (McNichols and Stubben 2008).

Lee, J. (2010), conducted a research on the role of accounting conservatism in financial decisions of companies and investigated effect of conservative procedures in financial reporting on companies' financial flexibility. Results of the research showed that companies with higher conservative degree had less financial flexibility in their liquidity management, financing decisions, sensitivity of investment to financial limitations and payment policies for shareholders.

The evidence linking conservatism to easier access to debt financing (Göx and Wagenhofer, 2009; García Lara, García Osma and Penalva, 2012) and improved credit terms (Zhang, 2008) is also consistent with the view that more conservative borrowers are less likely to expropriate debt-holders through accrual-based earnings management. Also, LaFond and Watts (2008) argue that managers have incentives to overstate earnings during their tenure to increase share price and, thus, their compensation. They argue that conservatism reduces management's ability to increase their wealth at the expense of shareholders, especially in firms with large information symmetries between managers and investors

Conservative accounting raises questions about the quality of the balance sheet. But the accounting for book values also affects the earnings calculation (of course). Earnings quality questions arise with conservative accounting because, with growth in investment, earnings are indeed lower than otherwise. But these lower earnings create hidden reserves. Hidden reserves can be increased, reducing earnings, by increasing investment. And hidden reserves can be reduced, creating earnings, by reducing investment or reducing the rate of growth in investment. If the change in investment is temporary, the induced change in earnings is also temporary and not indicative of subsequent earnings.

Considering the above-mentioned perspectives, this study to examines the accounting conservatism through corporate governance on earnings quality in manufacture companies. To be precise, this study seeks to answer this question: 1) What does accounting conservatism effect to earnings quality ? 2) What does accounting conservatism with accrual sizes effect to earnings quality ? 3) What does accounting conservatism with market value effect to earnings quality ? 4) What does accounting conservatism with accrual sizes and accounting conservatism with market value and effect to earnings quality?

## **2. THEORETICAL FRAMEWORK OF RESEARCH**

### **2.1 Accountig Conservatism**

Conservatism in a relative sense such that one practice (for example, accelerated depreciation) is considered more conservative relative to another if the accumulated amortizations it yields are greater than those for the other (and consequently the carrying value it yields is always less). Paek W., Chen L. and Sami L. (2007) found that, as predicted by Dechow, increase of conservatism reduced profit stability. Considering these results, they argued that enactment of accounting standards which contained conservative procedures implied costs for the capital market. These standards reduced earning predictability and made actual and potential investors deviate from correct economic decision making.

Conservatism creates fluctuation and in persistent earnings as well as the increase in information asymmetry (Mashayekhi et al., 2010) an extreme conservatism increases the

information asymmetry between the internal and external parties of a company (Wang, 2013), showed that when earnings conservatism is more significant, information asymmetry becomes more severe. In addition, when earnings conservatism is extreme or insufficient, its correlates with information asymmetry that produces a variety of effects and influences

Karami and Omrani (2009), studied effect of company's lifecycle and conservatism on its value. Results obtained from 450-year study of the company from 2003 to 2008 showed that investors preferred net operating assets and abnormal operating earnings of the companies in growth stage to those in maturity and decline stages. These results also demonstrated that investors in growth and maturity stages preferred net operating assets and operating earnings of conservative companies (to those which used aggressive accounting procedures) and the opposite process was held in the decline stage.

## **2.2. Corporate Governance Mechanism**

Corporate governance serves to create value in the firm. Corporate governance mechanisms have been devised to facilitate the control of management and groups of power in the firm and facilitate the achievement of maximisation of firm value. However, these corporate governance mechanisms are far from perfect. Their efficiency is limited by tradeoffs between control of the firm and protection of minority shareholder's. Governance at a corporate level includes the processes through which a company's objectives are set and pursued in the context of the social, regulatory and market environment. It is concerned with practices and procedures for trying to make sure that a company is run in such a way that it achieves its objectives, while ensuring that stakeholders can have confidence that their trust in that company is well founded.

The fundamental theoretical concepts of corporate governance are found in agency theory and the theory of managerial capitalism. The prime assumption of these theories is that when managers have substantial freedom, i.e. unrestricted by internal control mechanisms or external market forces, they are more likely to act in ways that enhance their own interests and not necessarily those of the equity holders.

Good corporate governance is a set of mechanisms that can protect the minority shareholders from expropriation by managers and controlling shareholders (insider), with an emphasis on legal mechanisms. The legal approach of corporate governance means that the key mechanism of corporate governance is the protection of external investors, both shareholders and creditors, through a legal system that can be interpreted by law and its implementation as an evidence that corporate governance structures and practices are important to support the quality of reported earnings, in particular by reducing earnings management opportunistic behavior, while other things on the one hand, accounting information plays an important role in the corporate governance process. While other things of evidence that corporate governance structures and practices are important to support the quality of reported earnings, in particular by reducing earnings management opportunistic behavior.

The structure of ownership affects the degree to which corporate contracts are enforced. individual stakes in firms affect the owners' abilities and incentives to enforce the property rights delineated by the contracts. Ownership concentration creates agency problems between the majority and minority shareholders when concentration reaches a level at which an owner obtains effective control of a firm.

### **2.3 Earning Quality**

Earnings quality is one of the important indicators for accurately evaluating the value of a company (Li, 2014). Dechow et al. (2010), explained that the high earning quality provides more information about company's performance that is relevant to a specific decisions made by specific the decision-maker. Furthermore, Demerjian et al. (2013), believed that the high earning quality accurately reflects the company's operating performance.

The earnings quality we have in mind is driven instead by real activity, accounting methods and estimates are not changed. Rather, given a (conservative) accounting policy consistently applied over time, earnings is temporarily affected by (real) investment. Manipulation and earnings management may or may not be intended by management but, if intended, the effect is achieved by an understanding of the joint effect of real activity and accounting policy. The effect is perverse: reducing investment reduces future earnings from investments but, with conservative accounting, reducing investment increases current earnings, making them a poor indicator of future earnings (Penman, 1999).

Gao and Wagenhofer (2013), show that well-governed firms optimally choose more conservative accounting, where they represent strong governance by low information acquisition costs. We also predict a positive relation between board governance and conservatism, but for different reasons. In addition, our model sheds light on the impact of reporting oversight on accounting manipulation and firm value.

Earnings quality issues arise, then, if a change in a reported accounting rate of return that is induced by a change in investment is temporary. If an analyst accepts the current book rate of return as an indicator of future rates of return, he or she will be misled if the reported rate of return is temporarily affected by the joint effect of conservative accounting and investment activity. But, if the analyst penetrates the joint effect, he or she will discover the reported number to be a poor quality indicator of long-run sustainable profitability. And quality of valuation issues also arise if valuations are made from forecasts of earnings.

### **2.4 Development of Hypotheses**

#### **Relation between Accounting conservatism and Earnings Quality**

We develop a model on the optimal level of conservatism and offer an alternative explanation for the positive relation between governance and conservatism. In our setting, consistent with previous arguments, conservative accounting produces information that enables boards to better oversee the investment decisions. However, the fact that conservatism facilitates board interventions causes the manager to manipulate the accounting system to mislead the board and distort its decisions. Acting in the best interest of shareholders, the board balances these benefits and costs to obtain an optimal interior level of conservatism. We show that boards that are more effective in restraining accounting manipulation can better exploit the benefits of conservatism and simultaneously curtail its costs, leading to a positive relation between the strength of reporting oversight and conservative accounting. We expect to find a significant effect accounting conservatism through corporate governance on earnings quality.

Zhang J. (2008), studied advantages of conservative accounting for parties of debt contracts and found that, in case of using conservative accounting and existence of provisions of conservatism accounting in the debt contract, creditors would gain advantages, such as payment of debt before maturity and imposing fine if debtors violate the provisions. On the other hand, creditors would expect less interest rate from the companies following conservatism accounting and borrowers would benefit from advantages such as less interest rate caused by reduced debt agency costs. Based on the description above, we posit the hypothesis as follows:

**H1:** Accounting conservatism effect on earning quality

### **Relation between Accounting Conservatism with accrual sizes and Earnings Quality**

Increase of conservatism reduced profit stability, Paek W., Chen L. and Sami L. (2007) found that considering these results, they argued that enactment of accounting standards which contained conservative procedures implied costs for the capital market. These standards reduced earning predictability and made actual and potential investors deviate from correct economic decision making. Bertomeu et al.'s (2013), results show that contracts can create, rather than eliminate, forces such that conservative accounting leads to manipulation. In contrast, we abstract from optimal contracting, and consider the usefulness of accounting reports for the board's oversight of the firm's investment decisions, when the board and the manager have conflicting investment interests, and the manager can manipulate accounting information to mislead the board,

The company's performance information can be affected by factors such as earnings quality Li, 2014), conservatism (Kazemi et al., 2011), and real earnings management (Gunny, 2010). Management choose and change its accounting policies, accounting estimates and corrections of errors to increase the relevance and reliability of the entity's financial statements and the comparability of financial statements of entities with financial statements of other entities (IAI, 2012). Bertomeu et al., (2013), show that conservative accounting can encourage manipulation in a setting in which the manager receives accounting-based compensation. There, the board designs an accounting system to induce productive effort at the lowest possible compensation cost. Based on the description above, we posit the hypothesis as follows:

**H2:** Accounting conservatism with accrual sizes effect on earnings quality

### **Relation between Accounting Conservatism with market value and Earnings Quality**

Earning quality affected attitude of capital market to changes of cash balance. It should be noted that presence of conservative procedures in financial reporting reduced discretionary accrual level and increased earning quality. Research results of Alope Ghosh, Zhaoyang Gu and Prem C. Jain (2009), investigated earning quality and earning response coefficient when stable increase of earning was accompanied by stable increase of income. Research results showed that companies with earning growth along with income growth had higher earning quality than those with growth along with cost decrease. Also, companies with increased income had higher operating future performance. Research results demonstrated that companies which had growth along with income had higher earning response coefficient.

In this paper, we examine the relationship between accounting conservatism through corporate governance and earnings quality around the manufacture company in Indonesia. Our main contributions are to empirically assess whether corporate governance and earnings quality play a substitution or a complementarity role in Indonesian sample, and also to assess to what extent this relation at firm level is shaped by the environment to which a firm belongs. The existence of a relationship between corporate governance and reported earnings has been broadly supported by the literature, both in theoretical and empirical studies. Yet, the relation between corporate governance and earnings quality is far from well understood.

Abedini, Bijan Mohammad Hosein Ranjbar and Azadeh Mozaffar (2014), accounting conservatism had negative effects on reaction of capital market to cash changes. In this regard, in case the company had a conservative policy in financial reporting, earning and other performance criteria based on accounting information would be underestimated. This event would potentially lead to negative reaction of investors because accounting earning is highly considered by the capital market. Based on the description above, we posit the hypothesis as follows:

**H3:** Accounting conservatism with market value effect on earnings quality

**H4:** Accounting conservatism with accrual sizes and market value effect effect on earnings quality

### 3. METHODOLOGY

#### 3.1 Population and Sampling Technique

The population of this study is made up of manufacture companies listed on the floor of the Indonesian Stock Exchange from year 2014 to 2016. This period is considered important due to the fact that the accounting conservative practices through corporate governance mechanisms on profit quality in manufacture companies listed on the exchange. Thus, sampling was done by purposive sampling method for 168 manufacture companies, meet the criteria a total 91 companies, total of data 91 companies x 3 years = 273 data of research.

#### 3.2. Measurement of Variables

Measurement Conservatism (Dependen Variable), Givoly and Hayn's index (2002) was used. The reason for selection of this model in the present research was that other conservatism criteria like Baso's model (1997) were based on capital market reaction while goal of the present research was to study reaction of capital market to cash changes under different degrees of conservatism or earning quality. Therefore, application of a criterion based on market reaction to conservatism could lead to disorder and colinearity in the hypotheses testing model. For this reason, Givoly and Hayn's model (2002), which was based on accounting information, was more suitable for the present research. Conservatism level was calculated based on this index through the following formula. The more the resulting value obtained from the formula, the higher the conservatism level would be.

$$CON = \frac{OACC}{TA} - 1 \dots\dots\dots (1)$$

Where CON : conservatism degree  
 OACC : operating accruals (difference between net operating earnings and operating cash flow)  
 TA : book value of assets

According to Givoly and Hayn (2000), accruals growth could be an index of change in accounting conservatism degree during a long-term period. In other words, if accruals increased, conservatism would decrease and vice versa. For this reason, accruals were multiplied by -1 to determine direction of conservatism changes.

Measurement variabel of accounting conservatism with accruals uses the desired regression models (Dependen Variable). The research hypothesis used testing method for variabel of accounting conservatism with accruals on earning quality. Therefore, developed model of accounting conservatism with accruals was used for its testing. In the above model, CON-ACC<sub>i,t</sub>. Main objective of the present research was to answer the question that whether accounting conservatism with accruals and market value effect to earning quality. The reflect conservatism level based on Wardhani Ratna's model (2010). CON-ACC<sub>i,t</sub> is a accounting conservatism with accruals variable and, in case conservatism level of company used corporate governance indicator,

This model was as follows:

$$CON\_ACC_{it} = \beta_0 + \beta_1 INDEP\_COM_{i,t} + \beta_2 BOARD\_OWN_{i,t} + \beta_3 COM\_AUD_{i,t} + \beta_4 INS\_OWN_{i,t} + \beta_5 FIRM\_SIZE_{i,t} + \beta_6 SALES\_GROWTH_{i,t} + \beta_7 PROF_{i,t} + \beta_8 LEV_{i,t} + \epsilon_{i,t} \dots\dots\dots (2)$$

Where CON\_ACC<sub>it</sub> = Accounting conservatism with accruals in year t for firm i  
 INDEP\_COM<sub>i,t</sub> = Commisaris Independent in year t for firm i  
 BOARD\_OWNI<sub>t</sub> = Owner Board in year t for firm i

- COM\_AUD<sub>i,t</sub> = Audit Commisaris in year t for firm i
- INS\_OWNI<sub>i,t</sub> = Owner Institusional in year t for firm i
- FIRM\_SIZE<sub>i,t</sub> = Size of Firm in year t for firm i
- SALES\_GROWTH<sub>i,t</sub> = Sales Growth in year t for firm i
- PROF<sub>i,t</sub> = Profit in year t for firm i
- LEV<sub>i,t</sub> = Leverage in year t for firm i
- ε<sub>i,t</sub> = e rror term (residuals) in year t for f irm i

Measurement variabel of accounting conservatism with market value uses the desired regression models (Dependen Variable), the research hypothesis used testing method for variabel of accounting conservatism market value on earning quality. Therefore, developed model of accounting conservatism with accruals was used for its testing. In the above model, KON-MV<sub>i,t</sub> reflects conservatism level based on Wardhani Ratna's model (2010). CON-ACC<sub>i,t</sub> is a accounting conservatism with accruals variable and,. Main objective of the present research was to answer the question that whether accounting conservatism market value effect to earning quality, in case conservatism level of company used corporate governance indicator, This model was as follows:

$$\text{CON\_MV}_{i,t} = \beta_0 + \beta_1 \text{INDEP\_COM}_{i,t} + \beta_2 \text{BOARD\_OWN}_{i,t} + \beta_3 \text{COM\_AUD}_{i,t} + \beta_4 \text{INS\_OWN}_{i,t} + \beta_5 \text{FIRM\_SIZE}_{i,t} + \beta_6 \text{SALES\_GROWTH}_{i,t} + \beta_7 \text{PROF}_{i,t} + \beta_8 \text{LEV}_{i,t} + \beta_9 \text{CURR\_RET}_{i,t} + \beta_9 \text{LAG\_RET}_{i,t} + \epsilon_{i,t} \dots \dots \dots (3)$$

- Where CON\_MV<sub>it</sub> = Accounting conservatism with market value in year t for firm i
- CURR\_RET<sub>i,t</sub> = Current return/  *Holding period return* in year t for firm i
- LAG\_RE<sub>i,t</sub> = Retur in year t less rreturn in year t -1 for firm i

Earnings Quality Variable (Independent Variable); This study uses the cross sectional variation of the modified Jones model, Dechow et al (1995), to measure discretionary accruals which is a proxy for earnings quality. Discretionary accruals have been extensively used as a proxy for earnings quality/ earnings management. Dechow et al (1995), argue that the modified Jones model is the most powerful model for estimating discretionary accruals. The desired index for measuring Quality of Earning (QE) was discretionary accruals level which was estimated using Jones' modified model. In this regression model, discretionary accruals were calculated by residual of total regression of accruals by sale, property and machinery (independent variables). Jones' modified model which was presented and applied by Kiotari et al (2005) was as follows:

$$\frac{TACC}{TA_{i,t-1}} = \alpha_1 \left( \frac{1}{TA_{i,t-1}} \right) + \alpha_2 \left( \frac{\Delta VREV_{i,t}}{TA_{i,t-1}} \right) + \alpha_3 \left( \frac{PE_{i,t}}{TA_{i,t-1}} \right) + \epsilon_{i,t} \dots \dots \dots (4)$$

- Where TACC<sub>it</sub> = total accruals in year t for firm i
- Δ REV = revenues in year t less revenues in year t -1 for firm i
- ΔREC<sub>it</sub> = receivables in year t less receivables in year t -1 for firm i
- PPE<sub>it</sub> = gross property, plant and equipment in year t for firm i
- E<sub>it</sub> = e rror term (residuals) in year t for f irm i

Higher accruals reflect lower quality level of earning. Thus, accruals obtained for discretionary accruals should be multiplied by -1 to estimate earning quality level (Barth *et al.*, 2009). According to Barth *et al.* (2009), the following was performed:

$$EQ_t = (-1) \frac{TACC}{TA_{i,t-1}} \dots \dots \dots (5)$$

## 4. RESULTS OF RESEARCH

### 4.1 Results of Statistick Output

The results of statistical tests to showed the purpose of this study. The value of R<sup>2</sup> (coefficient of determination) is 0.905 means that the hypothesis analysis gives an explanation of the effect of accounting conservatism, accounting conservatism with accrual size and market value showed significant resultson profit quality of 90.5%. The result of statistical process of SPSS V.22 is shown in table below.

Table. 1. Statistics Output

Description	Value			
R Square	0,906			
Adjusted R Square	0,905			
F hitung	864,260			
Probabilitas	0,000			
Description	Unstandardized Coefficients	Standardized Coefficients	Uji-T	Probabilitas (Sig. α 0,05)
Constant	-0,017		-1,570	0,205
CON	0,233	0,256	10,185	0,000
CON_ACC	0,271	0,304	9,578	0,000
CON_MV	0,243	0,495	14,998	0,000

Output SPSS V.22, (2017)

#### Results Obtained from Testing the First Hypothesis

The first hypothesis focused to effect of accounting conservatism on earning quality showed significant results, the effect of 23,3%. It indicated that, when earnings conservatism is more significant, information asymmetry becomes more severe. Results of the research showed that companies with higher conservative degree had less financial flexibility in their liquidity management, financing decisions, sensitivity of investment to financial limitations and payment policies for shareholders. The companies requires consideration in the face of uncertainty inherent in the company, especially for measuring and recognizing revenue, expenses, assets, and debts. Income and assets not otherwise too high (not exceed the fair value), as well as the debt burden and not be stated too low (not below fair value).

#### Results Obtained from Testing the Second Hypothesis

The second hypothesis to testing accounting conservatism with accrual sizes effect on earnings quality showed significant results, the effect of 24,3%. It indicated that, conservative accounting produces information that enables boards through corporate governance mechanisms to better oversee the investment decisions. However, the fact that conservatism facilitates board interventions causes the manager to manipulate the accounting system to mislead the board and distort its decisions in the best interest of shareholders, the board balances these benefits and costs to obtain an optimal interior level of conservatism. The second hypothesis showed that boards through corporate governance mechanisms that are more eective in restraining accounting manipulation can better exploit the benefits of conservatism and simultaneously curtail its costs, leading to a positive relation between the strength of reporting oversight and conservative accounting.



### Results Obtained from Testing the Third Hypothesis

The third hypothesis to testing accounting conservatism with market value effect on earnings quality showed significant results, the effect of 27,1%. It indicated that, research results showed that companies with accounting conservatism with market value through corporate governance mechanisms had negative effects on reaction of capital market to market value changes. In this regard, in case the company had a conservative policy in financial reporting, earning and other performance criteria based on accounting information would be underestimated. This event would potentially lead to negative reaction of investors because accounting earning is highly considered by the capital market.

### Results Obtained from Testing the fourth Hypothesis

The fourth hypothesis to testing accounting conservatism with accrual sizes and market value effect on earnings quality showed significant results. The results show that forces conservative accounting leads to manipulation. In contrast, we would be considering the usefulness of accounting reports for the board's oversight of the firm's investment decisions, when the board and the manager have conflicting investment interests, and the manager can manipulate accounting information. The result testing of multiple linear regression analysis:

$$Y = - 0,017 + 0,233 \text{ CON} + 0,271 \text{ CON\_ACC} + 0,243 \text{ CON\_MV} + \varepsilon$$

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