

# The Impact of Accounting Conservatism on Predicting the Financial Performance of Economic Units<sup>1</sup>

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## ABSTRACT

The rapid changes taking place in the modern business environment, the fierce competition between economic units, the scarcity of economic resources, and the exposure of many of them to financial failure or bankruptcy, predicting financial performance has become inevitable. Forecasting the financial performance of the Iraqi economic units.

And that the main objective of this research is to build a model to predict the financial performance of the Iraqi economic units. By using financial ratios and accounting conservatism, and verifying the effectiveness of accounting conservatism in helping to improve the ability of the model to forecast the financial performance of the Iraqi economic units.

The researcher used a special model to predict the financial performance of the economic units, through analyzing the financial statements of the research sample units, amounting to (55) economic units listed in the Iraq Stock Exchange from the research community consisting of (141) economic units listed in the market.

The researcher reached a set of conclusions, the most prominent of which is that the analysis of financial ratios is not a complete method of evidence in the analysis of financial statements, although its use is widespread, but it has some limitations and limitations due to the different administrative policies. It was found that the economic units with weak financial performance had a low level of accounting conservatism, relative to the units with good financial performance.

## INTRODUCTION

Accounting conservatism is a controversial topic in both accounting policy-making circles and academia, and very few accounting theorists favour the idea of undervaluing assets and exaggerating liabilities, delaying revenue recognition, and recognizing expenses too early. And, perhaps still, one of the most influential accounting principles in accounting practices (Sebrina & Taqwa, 2019:1). Although it has influenced the method of accounting for several centuries, there is no comprehensive and comprehensive definition of it (Xie, 2015:1), so in an attempt to put a broad definition of it, Bliss defined it as early as 1924, as the lack of Expect no profits, but rather all losses (Alkurdi et al., 2017:2). As for (Paton, 1948), he saw that conservatism is the lowest estimate of assets and net income through the use of different measurement methods (Hammad, 11: 2018). In the context of linking accounting conservatism to the goals of economic units and users of accounting information, Devine (1963) defined it as a rule that leads to lower average expectations of achieving the goal than alternative measurement and reporting rules (Zhong & Li, 2016:2)

In the Statement of Financial Accounting Concepts (2) developed by the Financial Accounting Standards Board (FASB, 1982), reservation is considered a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business activities have been adequately taken into account (Wardhani & Isnalita, 2019:3). In the same context, the International Accounting Standards Board (IASB 1989) defined it as a degree of caution in exercising the required judgments in making estimates under conditions of uncertainty (Xie, 2015: 2.)

Conservatism means using caution when making decisions under conditions of uncertainty. The conceptual framework indicates that conservatism, in general, is incompatible with the quality of impartiality because being

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cautious or conservative is likely to lead to bias in reported financial position and financial performance in reality (Kieso et al., 2018: 90)

Although accounting conservatism is one of the oldest and most dominant accounting constraints on the qualitative characteristics of accounting information, the theory lacks a unified definition of this concept. Therefore, the implicit meaning of conservatism is the recognition of costs or losses that are likely to occur. Still, it does not Income or profits, which will be realized despite the high probability of occurrence, are immediately recognized; that is, expenses must be recognized as soon as possible, revenue recognition must be deferred for as long as possible, and accounting conservatism is an approach that should be taken with uncertain circumstances, which requires a conservative attitude in Preparing the financial statements. This caution leads to the numbers in the financial statements being recorded lower or higher than the actual values.

## LITERATURE REVIEW

The Financial Accounting Standards Board (FASB) views accounting conservatism as compensation for an uncertain business situation, which many practitioners consider an essential characteristic of financial reporting. Yet, standard setters oppose it, demanding that financial information be neutral, free from intended bias. It may influence a decision or outcome. To this end, the Common Conceptual Framework (CF) should not include discretion or caution among desirable qualitative characteristics of accounting information. However, the framework should indicate the continued need for caution in the face of uncertainty (Hsieh et al., 2018:1). (FASB) has expressed the following opinion in this regard, indicating that accounting conservatism is related to not only the choice of accounting methods but also the estimate, which is often applied to accrual accounting, and that conservatism is an accounting practice that reduces profits (and decreases net assets) in the face of bad news, but does not increase profits (and increases net asset value) in response to good news (Pasupati, 2020:4)

Both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have moved away from viewing conservatism as a desirable characteristic of accounting information to emphasize the neutrality of accounting figures. However, some policymakers, motivated partly by understandable concerns, are related to the financial crisis (2009 -2007), they argued for more emphasis on precaution/conservatism. However, the academic literature needed to provide answers as to whether or how the conceptual framework (CF) could be adapted to accommodate conservatism, as well as the academic literature is not at a stage where it can be. It can help a lot in setting accounting standards, and part of the controversy surrounding conservatism and its role in the process of setting standards and practice comes from the ambiguity and different meanings attributed to the concept and the importance of the idea of conservatism and its relationship to other accounting concepts must be clarified before analyzing its determinants and consequences (Mora & Walker, 2015:2 The position of (IASB) and FASB oscillates in adopting accounting conservatism in their conceptual frameworks, and the idea appears in the FASB Concept Statement (No. The downgrading of conservatism in abstract thinking is without controversy, and the objection to including conservatism in the conceptual framework is based on the idea that conservatism indicates bias, bias is undesirable, and conservatism has been replaced by neutrality. This trait seems more flattering (Penman 2016:1)

A significant change in the IASB and FASB's stance toward reservation/precaution was announced by the 2006 Joint Discussion Paper and the 2008 IASB Presentation Draft, which included the first two chapters of the new CF, which explicitly introduced neutrality over prudence, and in (2010), the IASB and FASB release a review of CF, with its chapter on qualitative characteristics, which does not include precaution, and explains the basis for conclusions that precaution is omitted, as it is incompatible with neutrality. In the year (2012), (IASB) resumed its deliberations and issued a discussion paper on CF (2013), which does not contain the concept of precaution, and one of the reasons for removing this concept was the convergence with (GAAP), which did not have a definition of precaution, The other reason is that many felt that, in practice, the concept of prudence is often used as an excuse to manage earnings, and it seems that the main concerns of (IASB), and the apparent reasons for the absence of the concept of precaution in the discussion paper on (CF) is the evident incompatibility with neutrality And the possibility of misapplication of the concept of profit management, as well as the ambiguity and different meanings attributed to this concept (Mora & Walker, 2015:4). However, the discussion did not stop, and extensive public consultation identified priorities for updating the CF, and the goal of exploring the changes led the IASB to issue a Discussion Paper (2013) to obtain preliminary opinions and comments on important issues, to be considered by the IASB. While it was drafting a proposal to review the (CF), reservation was one of the goals of (CF) and one of the main issues at the (IASB) meeting in (May 2014), as the board provided positive news to all the supporters of the conservative movement, with the agreement of all its members to reintroduce caution in the conceptual framework. Secondly, the updated interpretation defined precaution as the prudent execution of judgments under conditions of uncertainty; furthermore, they emphasized that the exercise of prudence should be consistent with impartiality and should not allow for over- or under-valuation of assets, liabilities, income, or expenses (Therese 2015:15-16). In the year (2015) prudence was to

be reintroduced as part of the (CF) in the draft of (IASB for the year 2015), in which it was stated that neutrality supported by prudence is an alternative to reservation (Penman, 2016:2). The aim is to exercise caution under uncertainty to avoid overestimating net assets. In an article published on the official website of the (IFRS), (Steve Cooper, 2015), a member of the (IASB), stated that the old definition of reservation was not clear enough and left space for various interpretations and effects in financial reports and that the bias of reservation maybe is sometimes desirable. He regrets that the Council has not clarified the required meaning of the reservation (Therese, 2015:17). Over the past few years, the (IASB) has been preparing a review of the Conceptual Framework for Financial Reporting (CF), which defines the basic accounting concepts applied in the International Financial Reporting Standards (IFRS), as it was last reviewed in the year (2010). It was completed. The new revision in (March 2018) and (CF) states that the primary users of general-purpose financial reports are potential and current investors, lenders, and other creditors who need valuable information for decision-making. This information is helpful for decision-making and is relevant. It faithfully represents what It claims to describe, and for it to be beneficial, the notification must be as complete, impartial and error-free as possible, and there must be no bias in the selection or presentation of the data. This term needs to be clarified, and there is an ongoing debate among regulators, practitioners and researchers about what leads to helpful information or impartial or biased accounting. (Peric & Kozjak, 2020: 3)

Defenders of accounting conservatism claim that it serves as a degree of care when uncertainty prevails and acts as a disincentive for management to report overly optimistic results (Ahmed & Ali, 2015:3). Although conservative reports have raised criticism, its advocates emphasize the application of accounting conservatism in practice, and that there are four main reasons why economic units prefer to adopt conservative methods in accounting and financial reporting. These reasons include the contractual basis (contracts between stakeholders' internal and external factors such as directors, shareholders and creditors), litigation and litigation costs, current income tax reduction and regulatory incentives (Hejranijamil, 2020:2)

And political pressures from the European Parliament on the (IASB) and to avoid a repeat of the financial crisis (2007-2009) are pressing for a change in the prudential guidelines. In response, the President of the (IASB), (Hans Hoogervorst), described the Parliament's position as immensely worrying, Noting that pressure on the Council on this issue would raise concerns about its independence, just as the use of prudence could lead to non-impartiality of reported figures, and that the European Parliament's position on sense could negatively affect the perceived impartiality of the IASB's standard-setting process. However, the latest presentation draft of the conceptual framework includes the concept of precaution (Kieso, 2018:90)

Accounting conservatism benefits economic units by reducing agency problems, improving corporate governance and thus increasing the value of these units. Well-managed financial teams tend to use a more conservative tendency than poorly managed units (Ren, Y, 2014:58). (Kao & Sie) indicated that there is a positive correlation between accounting conservatism and predicting financial distress, and this means that when the trend of economic units changes towards the use of accounting conservatism significantly, this can be considered as one of the indicators of the possibility that these units will be exposed to financial hardship (Kao & Sie, 2016: 149)

(Vahed & Valipour) promised accounting conservatism that it is a practical tool to meet the requirements of corporate governance mechanisms or that it appears in their absence. It is one of the features of financial statements, which plays an important role within the framework of accounting principles and concepts to limit the opportunistic behaviours of managers (Valipour & Vahed, 2017: 173).

A study (Aminu, L., & Hassan) indicated the relationship between accounting conservatism and the performance of Nigerian banks, using information from a sample of 10 banks for five years (2012-2016). The results obtained from this study show that conservatism Conditional accounting has a positive relationship with these banks' performance. On the other hand, unconditional accounting conservatism was negatively associated with their performance (Aminu, L., & Hassan, 2017:124). (EL-Habashy) studied the effect of accounting conservatism on performance indicators of Egyptian economic units, by collecting a sample of information for more than 40 economic units, for the period from 2009-2014, using (Givoly & Hayn 2000) as a standard for measuring accounting conservatism, and the results showed The study showed that the high level of accounting conservatism in the process of preparing financial statements enhances the performance indicators of these units, and that policy makers must oblige economic units to adopt appropriate procedures to accept levels of accounting conservatism, to attract new investors and enhance the ability of these units to maintain stakeholders and enhance their confidence in their position Financial, and that accounting conservatism has a significant positive impact on performance indicators of economic units, as conservative accounting policies reduce the declared income of the economic unit while cash flows remain constant due to unrecognized profits, and this results in continuity of profits rather than continuity of accruals in subsequent years. It also leads to earnings quality which shows real earnings and helps predict real earnings in the future. This effect is reflected on the shareholders, which leads to a strong financial position for the economic unit (EL-Habashy, 2019: 9)

A study (Mohd et al.,) dealt with the financial performance of economic units that are compatible with Islamic law in Malaysia, for 24 economic units for the period from 2012 to 2017, and the results revealed that accounting conservatism is a feature of the financial statements of units that are compatible with Islamic law in Malaysia, and that Accounting conservatism has a positive correlation with financial performance, and Sharia-compliant units must have higher earnings quality compared to other economic units. The reason is that the establishment of Sharia law requires adherence to Islamic principles and directives that prohibit unethical behavior in the conduct of business. Hence, the practice of accounting conservatism alleviates the problem of management in unethical behaviors and helps in producing high-quality financial statements based on the application of international financial reporting standards (Mohd et al., 2020:292)

The study (Krismiaji and Sururi) examined the association of accounting conservatism (conditional and unconditional) with the quality of profits as well as with stock prices in economic units, using a sample of 282 units listed on the Indonesian stock exchange for the period from 2016 to 2018. The results of the study concluded that: (1) All analyzed economic units apply conservative accounting policies and practices, (2) stock prices and earnings quality are negatively related to conditional conservatism, (3) unconditional accounting conservatism is positively associated with earnings quality, and (4) unconditional accounting conservatism is negatively associated With stock prices (Krismiaji and Sururi, 2021:48).

The impact of accounting conservatism on financial performance in service units listed on the Amman Stock Exchange was identified in the study of Al-Fasfus et al.), as accounting conservatism was measured through the accrual-based model (Givoly & Hyans, 2000), on a sample. From (23) service companies listed on the Amman Stock Exchange during the period from 2015 to 2019. The results of the study showed a positive impact of accounting conservatism on the performance of these units (AL-Fasfus et al., 2022:296). Contrary to the study of in their study of 168 economic units listed on the Tehran Stock Exchange for the period from 2012 to 2017. They found that despite the use of various conservative accounting methods to prevent management from Exaggerating profits, economic units that have more conservative procedures are more likely to report profits of lower quality, and one possible reason for such a relationship is that the use of conservative practices may create some mistrust for users of financial information (and can be considered as manipulation of profit figures) ( Zadeh et al., 2022:14).

Through previous studies, the researcher found that the majority of these studies supported that accounting conservatism has a positive effect on the profits of economic units, and it plays an important role in monitoring senior managers, and contributes to reducing problems resulting from information inconsistency, and accounting conservatism applied in financial statements can prevent discrepancies Information and manipulation of financial data, and each economic unit should exercise caution in preparing financial statements to be able to calculate the resulting financial information to provide benefits to each user, and this proves that accounting conservatism can be an alternative governance method to improve the performance of economic units.

## RESEARCH METHODS

The level of accounting conservatism will be measured through the (AACF) model of (Ball and Shivakumar 2005), and the idea of this model is based on the accruals, which is the net profit after subtracting the operating cash flows from it, and its negative value over a period of time indicates that the cash flows continue more of profits, and this is evidence of the use of conservative accounting policies by the economic unit, and through the following equation:

$$\text{Acc}_{i,t} = \beta_0 + \beta_1 \text{DCFO}_{i,t} + \beta_2 \text{CFO}_{i,t} + (\beta_3 \text{DCFO}_{i,t} \times \text{CFO}_{i,t}) + \varepsilon_{i,t}$$

**Acc i, t:** accruals from operations, which are measured by:

**Operating revenue for year t minus operating cash flow for year t divided by total assets for the previous year.**

**DCFO i, t:** a dummy variable that takes the value of (1) if the cash flows from operating operations are negative and takes the value of (0) if otherwise.

**CFO i, t:** cash flows from operating operations for period t divided by total assets for the previous year.

**DCFO i, t × CFO i, t:** represents accounting conservatism.

The data of 2017 were used in addition to the data of 2018-2019, because this model needs a minimum of 3 years to be used.

**Table (1): Measuring accounting conservatism in the banking sector**

2019	2018	CO.	N
0.00001	0.00242	Assyria Bank	1
0.00003	-0.00008	Iraqi Investment Bank	2
0.00025	0.00012	National Bank of Iraq	3
0.00009	0.00071	United Bank for Investment	4
-0.0003	0.04591	Mansour Investment Bank	5
0.01268	-0.00194	Elaf Islamic Bank	6
-0.00027	0.0021	Iraqi Commercial Bank	6
-0.00085	-0.06386	Gulf Commercial Bank	7
0.00007	0.00037	Middle East Investment Bank	8
-0.03054	0.00242	North Bank for Finance and Investment	10
0.00086	-0.00064	Mosul Bank for Development and Investment	11
0.0005	-0.00004	National Islamic Bank	12
-0.00056	-0.00022	Bank of Babylon	13
-0.0014	0.00037	Baghdad Bank	14
0.00037	-0.00149	Sumer Commercial Bank	15
0.00131	-0.0018	credit bank	16
0.00243	0.00131	Kurdistan Bank	17

The results of measuring accounting conservatism for the banking sector were obtained after testing the accounting conservatism measurement model (Ball & Shivakumar 2005)) by determining the regression coefficient for the accounting conservatism measurement model ( $DCFO_{i,t} \times CFO_{i,t}$ ) for the years 2018 and 2019 for the purpose of doing it later Measuring the impact of accounting conservatism on predicting financial performance. Noting that the majority of banks tend to use accounting conservatism during the school years, due to the positive value of the regression coefficient, which in this case indicates the extent of the economic unit's commitment to accounting conservatism.

**Table (2): Measuring accounting conservatism in the insurance**

2019	2018	CO.	N
-0.00075	0.00017	Al Amin Insurance	1
0.01187	-0.00133	Insurance eligibility	2
0.00289	0.00025	Al Hamra Financial Insurance	3
-0.00013	-0.00017	Gulf Insurance	4
0.00232	0.00035	Dar Al Salam Insurance	5

The results of measuring accounting conservatism for the insurance sector were obtained after testing the accounting conservatism measurement model (Ball & Shivakumar 2005) by determining the regression coefficient for the

accounting conservatism measurement model ( $DCFO_{i,t} \times CFO_{i,t}$ ) for the years 2018 and 2019 for the purpose of doing it later. By measuring the effect of accounting conservatism on predicting financial performance. Noting that the majority of insurance companies tend to use accounting conservatism during the years of study, except for (Gulf Company), which showed through the results weak conservatism in 2018 and 2019. This is due to the positive value of the regression coefficient, which indicates in this case the extent to which the rest of the insurance companies adhere to accounting conservatism.

**Table (3) : Measuring the financial performance of the banking**

financial performance		2019	2018	2017	CO.
2019	2018				
1	0	0.024	0.019	0.054	Assyria Bank
0	0	0.0001	0.001	0.016	Iraqi Investment Bank
1	0	0.037	-0.032	0.012	The National Bank of Iraq
0	0	-0.007	-0.056	-0.010	United Bank for Investment
0	1	0.033	0.085	0.059	Mansour Investment Bank
1	0	0.004	0.003	0.008	Elaf Islamic Bank
0	1	0.026	0.047	0.040	Iraqi Commercial Bank
0	1	-0.013	0.002	0.014	Iraqi Gulf Bank
1	0	0.0003	-0.009	-0.002	Middle East Investment Bank
0	0	-0.042	-0.052	-0.042	North Bank for Finance and Investment
1	0	0.014	0.010	0.019	Mosul Bank for Development and Investment
0	0	0.006	0.031	0.101	The National Islamic Bank
0	1	0.006	0.015	0.014	Bank of Babylon
1	0	0.029	0.017	0.024	Baghdad Bank
1	1	0.004	0.004	0.002	Sumer Commercial Bank
0	0	-0.020	0.022	0.027	credit bank
0	0	0.006	0.018	0.104	Kurdistan Bank

This data represents the earnings per share for the economic units in the Iraqi banking sector, which was calculated by dividing the net profit by the number of shares. For the three years (2017-2018-2019) and through the above table it is clear that only (Mansour Investment Bank, Iraqi Commercial Bank, Iraqi Gulf Bank, Babel Bank, Sumer Commercial Bank) performed well during 2018. As for the rest of the banks during 2018, it was They perform poorly. The above table also shows that the nature of the banks' performance in 2019 was good for the banks (Ashur Bank, the National Bank of Iraq, Elaf Islamic Bank, Middle East Investment Bank, Mosul Bank for Development and Investment, Bank of Baghdad) or the rest of the banks had poor performance.

**Table (4): Measuring the financial performance of the insurance**

financial performance					CO.
2019	2018	2019	2018	2017	
0	0	-0.007	-0.001	-0.001	Al Amin Insurance
0	0	-0.108	-0.048	-0.049	Insurance eligibility
1	0	0.626	0.088	0.130	Al Hamra Financial Insurance
0	0	0.005	0.083	0.098	Gulf Insurance
1	0	0.020	0.005	0.018	Dar Al Salam Insurance

Table (4) shows that the performance of the economic units in the insurance sector was weak during the year 2018. As for the year 2019, the performance was good for the monetary units (Al-Hamra Financial Insurance, Dar Al-Salam Insurance) to achieve growth in earnings per share. As for the rest of the teams, their financial performance could have improved.

**Table (5)The results of the classification of financial performance prediction through financial ratios and accounting conservatism**

	Financial performance	Predicted Membership		Group	Total	CCR
		.000	1.00			
Original	Count	.000	22	8	30	70.9%
		1.00	8	17	25	
	%	.000	73.3	26.7	100.0	
		1.00	32.0	68.0	100.0	

It is evident from the results obtained in Table (5), which presents the number of economic units with strong financial performance and weak financial performance represented by 30 monetary units with weak financial performance and 25 other economic units with strong financial performance. The classification was found to be accurate, with a rate of 70.9%.

The function used by the researcher classified economic units with poor performance by (22) monetary units correctly, with a rate of (73.3%), and (8) financial departments incorrectly classified, as it mistyped them, with a rate of (26.7%), as suitable monetary units.

As for the economic units with good performance, the function used by the researcher classified them with (17) monetary units correctly, with a rate of (68%), and it was wrong with (8) economic units, as it classified them incorrectly, with a rate of (32%), as poorly performing monetary units.

**CONCLUSION**

The results of the above table showed that the area of the (ROC) curve was (0.730) and (0.707) for the years 2018 and 2019, respectively, at a significant level less than 0.05, and that this proves the fifth hypothesis, which states (that the use of financial ratios and accounting conservatism can improve of the accuracy of the model for predicting the financial performance of economic units), as the ratios reached by the fifth hypothesis exceeded the ratios in the fourth hypothesis, which means improving the accuracy of the model. The analysis of financial ratios is not a complete method of evidence in the analysis of financial statements, although its use is wide spread, but it has some determinants and limitations due to the different administrative policies. It was found that the economic units with weak financial performance had a low level of accounting conservatism, relative to the units with good financial performance.

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