

The Effect of Unconditional Conservatism on Market Reactions

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Abstract. This study aims to investigate the effect of unconditional conservatism on market reactions. The study was conducted on non-financial companies in the Indonesia stock exchange in the period 2011-2016, and used stepwise regression for data analysis. The results showed that unconditional conservatism had a positive effect on market reactions. Investigations in different periods, namely the period 2011-2015 and 2011-2016 show that the influence of unconditional conservatism is increasingly positive on market.

Keywords: Unconditional conservatism · Market reactions · Non-financial companies

1 Introduction

Indonesia cannot avoid the manipulation of financial statements due to weak integrity, as the case of PT Tambang Timah allegedly providing fictitious financial reports related to the press release of the first semester of 2015 financial statements states that efficiency and strategy have led to positive performance being contradictory to the company's financial condition less healthy (Soda, 2016). Environmental uncertainty in economic and business activities requires caution in recognizing assets and profits, where the integrity of financial statements can be measured by applying the conservatism index.

Watts (2003) states that conservative accounting practices prevent companies from exaggerating earnings and help users of financial statements in presenting non-overstated earnings and assets so that conservative accounting results in higher quality earnings. Based on their role, experts distinguish the concept of conservatism into two categories, namely: conditional conservatism and unconditional conservatism (Beaver & Ryan, 2005; Ruch & Taylor, 2015; and Zhong & Li, 2016).

The two concepts of conservatism have different but interrelated roles, where unconditional conservatism can reduce conditional conservatism (Qiang, 2007). Using a conditional conservatism index, research by Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019) proves that conservatism has a negative effect on market reactions when interacted with cash changes.

Different from measurement of conservatism in the Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019) studies, this study investigates unconditional conservatism. Research conducted by Indriani & Amalia (2019) uses one research

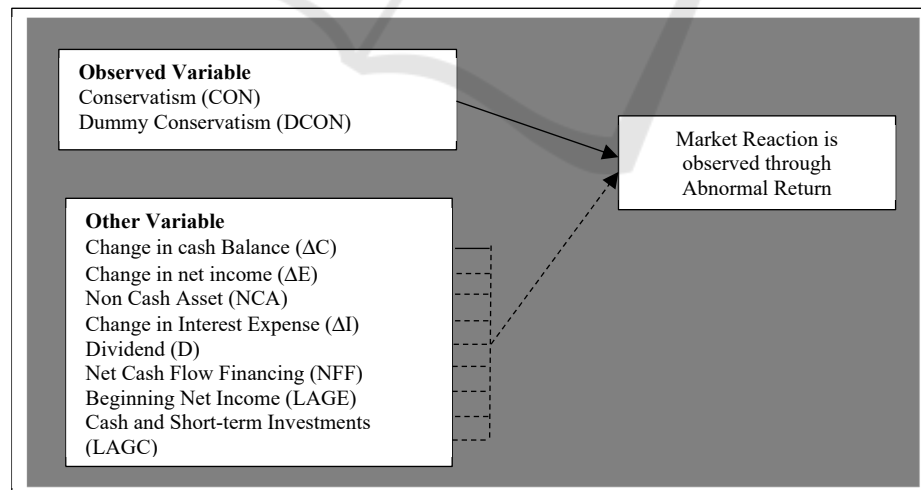
period, and this study examines it in two periods, namely the 2011-2015 period and the period by extending the observation year 2011-2015.

2 Literature Review

Basu (1997) defines conservatism as the practice of reducing earnings (and minimizing net assets) in response to bad news (bad news), but does not increase profits (raising net assets) in response to good news (good news). The opinion of Basu (1997) is also supported by Penman & Zhang (2002) stating that conservatism which is more descriptive is to choose accounting principles that lead to minimization of reported cumulative earnings, namely recognizing slower income, recognizing faster costs, valuing assets with more value low.

Ruch & Taylor (2015) stated that accounting researchers have identified two broad forms of conservatism that produce the aforementioned understatement of accounting value: (1) conditional conservatism, and (2) unconditional conservatism. The primary difference between the two forms of conservatism is that the application of conditional conservatism depends on economic news events, while the application of unconditional conservatism does not. It is important to distinguish between conditional and unconditional conservatism, because two forms of conservatism have different effects on the financial statements; and research suggests that the application of one type of conservatism affects the application of the other type.

Research by Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019) who investigate conditional conservatism, proves that conservatism has a negative effect on market reactions when interacted with cash changes. Whereas Beaver & Ryan (2005) found that unconditional conservatism and other factors preempt conditional conservatism and so on the asymmetric response of earnings to positive and negative share returns, both current and lagged. Following the research Indriani & Amalia (2019) this research framework is presented in Figure 1.



Source: Indriani & Amalia (2019)

Fig. 1. Research Framework.

3 Research Methodology

This research is included in a positive paradigm that uses a quantitative approach and is an empirical research (empirical research), intending to test the proposed hypothesis. The observation unit (population) in this study is non-financial companies listed on the Indonesia Stock Exchange in the period 2011-2015 and 2011-2016. The data collection method in this study was done by purposive sampling as presented in Table 1 related to the research sample

Table 1. Number of Research Samples Based on Criteria.

Criteria	Period	Year 2011-2015		Year 2011-2016	
		N	(%)	N	(%)
The number of non financial companies attending stock exchange		447	100	426	100
The number of Company data is incomplete		(28)	(6,3)	(16)	(3,7)
The number of Companies listing on the IDX after 2010		(104)	(23,2)	(106)	(24,9)
The number of Companies that report financial statements with currencies other than rupiah		(66)	(14,8)	(62)	(15,6)
The number of Companies that move sectors		(1)	(0,2)	(1)	(0,2)
The number of Companies that do not have LK in 2016 (Mergers, Losses and others)		(7)	(1,6)		
The number of Companies that meet the criteria		241	53,9	241	56,6
Year of Observation		5		6	
Number or sampel		1205		1446	

Source: Secondary data processed.

Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019) research investigating conditional conservatism. This research investigates the effect of unconditional conservatism (balance sheets) for users of financial statements (investors). Conservatism in this study was measured using the C Score index by Penman & Zhang (2002) to determine the level of accounting conservatism on the balance sheet, which is the sum of research and development costs by depreciation costs divided by net operating assets. The multiple regression equation model that will be examined in hypothesis testing is as follows according to the research of Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019):

$$ABRET_i = \beta_0 + \beta_1\Delta C_i + \beta_2CON_i + \beta_3DCON_i + \beta_4\Delta C_i * CON_i + \beta_5\Delta C_i * DCON_i + \beta_6LSPT_i + \beta_7NCA_i + \beta_8\Delta I_i + \beta_9\Delta D_i + \beta_{10}NF_i + \beta_{11}LAGE_i + \beta_{12}LAGC_i + \beta_{13}LAGL_i + \beta_{14}\Delta C_i * LAGE_i + \beta_{15}\Delta C_i * LAGC_i + \beta_{16}\Delta C_i * LAGL_i + \varepsilon_i$$

Explanation:

$ABRET_i$: Abnormal return (market adjusted model)

ΔC_i : Changes in the company's cash balance in year t compared to t-1

CON_i : Unconditional conservatism uses the C-Score index

$$C_{it} = \frac{RnD_{it} + DEPR_{it}}{NOA_i}$$

$DCON_i$: Dummy variable, the level of conservatism, is 1 if conservatism is negative and 0 if the opposite is true (C-Score)

$\Delta C_i * CON_i$: Changes in cash balances are multiplied by conservatism

$\Delta C_i * DCON_i$: Changes in cash balances are multiplied by conservatism dummy

$LSPT_i$: Changes in net income before unexpected items in year t compared to t-1 as a control variable.

NCA_i : Changes in the company's non-cash assets in year t compared to t-1 as a control variable

ΔI_i : The change in the company's interest expense in year t compared to year t-1 as a control variable

ΔD_i : Change in company dividends in year t compared to t-1

NF_i : Net cash flow funding activities as a control variable

$LAGE_i$: Net income before unexpected items is divided by the company's market value at the beginning of the period as a control variable

$LAGC_i$: Total cash and short-term investments divided by market value at the beginning of the period as a control variable

$LAGL_i$: Company leverage, total debt divided by total assets as a control variable.

$\Delta C_i * LAGE_i$: Changes in cash balance times net income before the unexpected items are divided by the market value of the company at the beginning of the period

$\Delta C_i * LAGC_i$: Changes in cash balance times total cash and short-term investments divided by market value at the beginning of the period

$\Delta C_i * LAGL_i$: Changes in cash balance times the company's leverage, total debt divided by total assets

β_0 : Constanta

$\beta_1, \beta_2, \dots, \beta_{16}$: Coefficient Regression

ε_i : Error

Based on the research framework and research mathematical equations, in addition to conservatism and in line with the Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019) studies involving variables of changes in cash, net operating income, non-cash assets, interest, dividends, net cash flow financing activities, cash plus short investment, and leverage. In addition to leverage, control variables are scaled to market value.

Hypothesis testing uses the t test, which is by looking at the value of ρ -value and the direction coefficient β_4 (KCON) and β_5 (KDCON). This study uses a level of confidence (level of significant) 95% with ρ -value (α) = 5%, with β_4 and β_5 negative values. If the variable has a p-value <0.05 then it has a significant effect.

4 Result and Discussion

Table 2 presents descriptive data statistics in this study, which consists of minimum, maximum, average, and standard deviation of variables in the research equation.

Table 2. Descriptive Statistics.

	Year 2011-2015					Year 2011-2016					
	n	Min	Max	Mean	St Dev	n	Min	Max	Mean	St Dev	
ABRET _i	1205	-0.0943	0.9158	0.0106	0.0809	1446	-0,0943	0,9234	0,0127	0,0999	
ΔC_i	1205	-1.1362	2.9363	0.0161	0.2032	1446	-3,5793	3,0048	0,0150	0,2320	
CON _i	1205	-0.5948	1.5278	0.0279	0.0964	1446	-6,8012	2,9245	0,0318	0,2979	
ΔE_i	1205	-12,2068	11,6921	0.0280	0.6021	1446	-12,2068	11,6921	0,0359	0,6543	
NCA _i	1205	-28,9557	11,2707	0.1995	1.2484	1446	-28,9557	11,2707	0,1599	1,3486	
ΔI_i	1205	-0,7549	4,8812	-0.0016	0.1720	1446	-0,7549	4,8812	-0,0008	0,1586	
ΔD_i	1205	-1,3579	3,4746	-0.0003	0.1215	1446	-1,3579	9,0123	0,0089	0,2804	
CFF _i	1205	-16.2520	7.9510	0.0519	0.6774	1446	-20,8766	8,9887	0,0358	0,8870	
LAGE _i	1205	-1.9171	7.5761	0.4215	0.6265	1446	-12,0081	12,8976	0,43067	0,8716	
LAGC _i	1205	0.00001	6.4680	0.2215	0.4825	1446	-1,2478	6,5608	0,2207	0,4854	
LAGL _i	1205	0.0003	16.6616	0.5566	0.8504	1446	0,0001	17,5554	0,5658	0,9263	
Categorical Variable											
Category	Dummy	(n)	(%)				(n)	(%)			
DCON _i Apply conservatism	1	1164	97%				1391	96,2%			
DCON _i do not apply	0	41	3%				55	3,8%			
Total		1205	100%				1446	100%			

Source: Secondary data processed.

Stepwise Regression Testing. Investor's reaction regarding the application of unconditional conservatism is the focus of this research. The results of the stepwise multiple linear regression analysis for the C-Score model are presented in Table 3.

Table 3. The results of the Stepwise Multiple Linear Regression Analysis for the C-Score Model.

	Year 2011-2015		Year 2011-2016	
	<i>Coef. β</i>	<i>Sig</i>	<i>Coef. β</i>	<i>Sig</i>
CON _i			0.062	0.019
LAGE _i	0.101	0.002		
LAGC _i	-0.075	0.021		
<i>Adj. R²</i>		0.007		0.003
F		5.346		5.545
Sig		0.005		0.019

Source: Secondary data processed.

Table 3 can be concluded that the effect of unconditional conservatism is not consistent in the two testing periods, so this study uses the results of the standardized coefficient in the equation. Using stepwise regression, unconditional conservatism is not included as a variable that influences the market reaction in the period 2011-2015. But the reverse happened in the period 2011-2016 where only unconditional conservatism variables that entered affected the market reaction. The testing period of 2011-2016 accounting conservatism has a significant positive effect on market reaction (abnormal return)

Discussion of the Effect of Unconditional Conservatism on Market Reactions.

Based on hypothesis testing using the C-Score model, it is obtained inconsistent results related to the effect of unconditional conservatism on market reaction. In the 2011-2015 period, unconditional conservatism is not a variable that affects market reactions, but in the 2011-2016 period, unconditional conservatism has a positive effect on market reactions. This influence is different from the results of research Abedini, Hosein, & Mozaffari (2014) and Indriani & Amalia (2019), which shows that conditional conservatism has a negative effect.

. Unconditional conservatism, also called news-independent or ex ante conservatism would prevent such conditional conservatism from improving contracting efficiency and could even distort financial reporting used by investors (Zhong & Li, 2016). Earlier Beaver & Ryan (2005) concluded that unconditional conservatism and other factors preempt conditional conservatism and so affect the asymmetric response of earnings to positive and negative share returns, both current and lagged.

5 Conclusion

Unconditional conservatism is reacted positively by the market, where investors as market participants assume that conservatism in the balance sheet is good news. However, this reaction is not consistent in the observed period, where in the first period conservatism is not a variable that influences market reaction, whereas in the second

period unconditional conservatism becomes the only variable that affects the market reaction of the variables included in the mathematical equation. Therefore, it is concluded that unconditional conservatism in this study is only able to explain in the sample period of the study and cannot be used to predict.

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