

VALUE RELEVANCE OF ACCOUNTING INFORMATION: THE MODERATING EFFECTS OF ACCOUNTING CONSERVATISM IN A FRONTIER MARKET

Abogun Segun¹

Olowookere J. Kolawole²

Kasum A. Sadiq

Abstract

This study examined the value relevance of accounting information and the moderating effect of conservatism on the value relevance of earnings. The Ohlson equity valuation model was used in this study as basis for model specification. Explanatory research design was employed and as such, panel data were obtained from secondary sources. The model of the study was estimated using panel fixed effect estimation technique. The study found that accounting information, which includes earnings, book value of equity, dividend, and conservatism have significant impact on share price. The interaction term, which measured moderating effect, was significant. Therefore, the study concludes that accounting information is value relevant, and conservatism moderates the value relevance of earnings. Hence, it is recommended that accounting conservatism be applied in a greater measure by company chieftains in preparing financial statements.

Keywords: Accounting information, Conservatism, Value relevance, Earnings, Ohlson Model.

Introduction

Value relevance is a trending issue in the field of financial reporting and investment decision making by investors. The field of accounting generally is about providing information for various users. These users have different information needs, which may be conflicting sometimes. As such, a general purpose financial statement is prepared by directors of firms and which has been viewed to meet the common information need of these different users (Sutton, Cordery, & van Zijl, 2015). The belief is that information need of these users is known and is provided for in the general purpose financial statement. In addition, the assumption is that most users need information for economic decision; that is, users' decisions are usually connected to the economic effect of firms' financial transactions. Therefore, since the hallmark of the general-purpose financial

¹ Dept. of Accounting, University of Ilorin. segunstc@yahoo.com (+2348039156876)
abuska@unilorin.edu.ng

² Dept. of Accounting, Osun State University. Johnson.olwookere@uniosun.edu.ng

statement is to provide information for economic decision, there is a common ground; and as such, it is assumed capable of meeting the need of every user. Another rationale for the general-purpose financial statement is the fact that only the management out of all users has the power and access to obtain information to meet its unique need. Others are not empowered by law to place demand on the company to prepare a separate financial statement unlike the management (internal user). Besides, the costs of preparing separate financial statement for each user may be burdensome and overwhelming to the company. Such practice may erode significantly the fortunes of the owners of the company (in this case, the equity holders).

It is important to note that while the general-purpose financial statement is assumed to provide information needed by all users groups, the primary audience for which it is prepared is the investors, lenders and other creditors (IASB, 2010). Despite the fact that the general-purpose financial statement is directed to investors, lenders, and other creditors; however, other categories of users are assumed to find it useful. In the same manner, the International Accounting Standards Board (hereafter, the Board) recognises the fact that the general purpose financial statement is limited in providing all the information needed by existing and potential investors, lenders and other creditors; thereby recommending that additional information be obtained from other sources. Similarly, the Board also accepts the fact that the general-purpose financial statement is not designed to give the value of an entity; instead, it is designed to provide information that would enable investors (existing and potential), lenders and other creditors estimate firm value. This implies that financial statement information is expected to serve as input into models used for estimating firm value.

There are many economic decisions that could be made based on financial statement information but most important among them are to assess the stewardship and accountability of management, and the decision on buying, selling or holding equity and debt instruments. This further validates the fact that financial statement is directed primarily to investors, lenders and other creditors. However, despite the fact that the primary objective of the general-purpose financial statement is targeted at providing information for economic decisions, there are observed problems believed to have hampered the achievement of this objective. It observed that the model of preparing the financial statement is strongly conflicting with the objective of financial reporting. There is no perfect match between the two. The financial statement is prepared based on historical cost model and capital maintenance concept. Consequently, these models and concepts are component that make up accounting conservatism. Ruch and Taylor (2015), describe accounting conservatism as accounting practice that results into a reduced value of accounting net assets compared to the economic value of net assets. Applying these concept and model as basis for preparing the financial statement may limit significantly its capacity to deliver on providing information for economic decision. The economic decision emphasised involves buying,

selling or holding equity and debt instruments. The board admits that: “*other models and concepts may be more appropriate in order to meet the objective of providing information that is useful for making economic decisions*”. The observed decline in the value relevance of financial statement information may not be unconnected to the direct effect of applying historical cost model and capital maintenance concept. It is against this background that this study attempts to examine the value relevance of preparing financial statement under the accounting conservatism principle. In examining this problem, the application of Ohlson (1995) model is crucial because the model establishes a link between share price and financial statement information.

The motivation for this study is drawn from the fact that previous studies have given attention to value relevance of earnings, book value of equity, dividend, and adoption of International Financial Reporting Standards with little or no attention on the effect of accounting conservatism on share pricing decisions by investors. Furthermore, this study is also unique in the sense that it examined the moderating effect of accounting conservatism, which was not examined by previous studies. Examining the moderating effect of accounting conservatism is crucial now that there are reports, which claim that financial statement information is not so relevant for investors’ decisions. These claims suggest that there is need for reassessment of accounting principles and practice and one of such important principles is conservatism. On this premise, this study was carried out to examine the effect of conservatism on the value relevance of financial statement information.

More so, most of the studies carried out previously emanated from developed, emerging, and underdeveloped market. Little or no study has examined the value relevance of accounting conservatism from a frontier market such as Nigeria. More importantly the country Nigeria is central in defining the strength of economic activities in the African continent; hence, quoted firm on the Nigerian stock exchange is examined in this study.

Literature Review

Conceptual Issues

The concept of value relevance as entrenched in the literature has been defined as the ability of accounting information to capture the information contained in the market value equity (Filip & Raffourner, 2010). If the information contained in market value of equity is captured by financial statement information, then it is considered value relevant (Bhatia & Mulenga, 2019; Outa, Ozili & Eisenberg, 2017; Purswani & PS, 2017). Value relevance is connected to investment decision of equity investors which includes buying, holding, selling off of shares (Ezejiofor, Peace, & Jane, 2016). The accounting information referred to here, includes but not limited to earnings, book value of equity, and dividend. Earnings are the results of operations of firms. It is what is left after all operating expenses have been recovered from revenue. It is also a strong basis for assessing management efficiency and effectiveness. Book value of equity is

accounting measure of equity value. It is also referred to as the net assets of a firm measured by the difference between total assets and total liability of the firm (Senthilnathan & Kajoon, 2013). Dividend is the gain on investors' fund apart from capital appreciation on the investments (Salman, Lawal, & Anjorin, 2015). It is that part of profit that is given to shareholders (Matthew, Enekwe, & Anyanwaokoro, 2014).

Following the measurement view of measuring value relevance, the emphasis is the ability of financial statement information to contain a summary of information captured by market value of equity regardless of the time such information is released into the market. This is contrary to the information view which defines value relevant information as that which causes downward or upward movement in share price around the period when such information is released (Francis, Schipper, & Vincent, 2002). The measurement view measures value relevance as the correlation between share price and accounting information (Habib & Weil, 2008). Furthermore, the R-squared resulting from share price regression is also used for measuring value relevance. On the other hand, according to the Statement of Financial Accounting Concept (SFAC) No. 2 of FASB (2008), conservatism is defined as: "...a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using less optimistic estimate..."

The definition provided above implies that accounting conservatism is the practice of anticipating and providing for all losses whether or not they have actually occurred while revenue and income are delayed until they have actually occurred. The application of accounting conservatism to income statement therefore requires that items of revenue, income or profit should not be anticipated whereas all probable losses must be provided for in the income statements. In the financial position statement, the application of accounting conservatism requires that the lowest value amongst several other possible values is used as carrying amount for assets while the highest value amongst other possible values is used as the carrying amount for liabilities (Watts & Zimmerman, 1986; Dutta & Patatoukas, 2015).

This practice of recognising all probable losses and delaying all probable incomes until they have occurred has some consequences in terms of its costs and benefits depending on whether the financial statement is used for valuation purposes or for contract settlements. However, the general consequence of conservatism principle is that the net assets based on accounting records is perpetually kept lower than the economic value of net assets. This is why Basu (1997), Watts (2003), Bandyopadhyay, Chen, Huang, and Jha (2010), Chen, Folsom, Paek, and Sami (2014), Ruch and Taylor (2015) describe accounting conservatism as accounting practice that results into a reduced value of accounting net assets compared to the economic value of net assets. The costs and benefits of accounting conservatism is contentious in the literature in the sense

that some studies argued strongly that the costs of applying conservatism in the preparation of financial statements outweigh its benefits while some other studies argued in favour of the application of accounting conservatism.

The arguments forwarded by the advocates of accounting conservatism are uncertainties surrounding business operation, asymmetric pay-off between borrowers and lenders of fund, and the agency problem between owners and management (Xie, 2015). Concerning the uncertainty linked to business environment, there are certain events that management especially the reporting accountant has to contend with. For instance, the collection of doubtful trade receivables is uncertain; determination of the useful life of non-current assets is equally uncertain. Discount allowable on receivables is doubtful, and the determination of court cases before the court judgment is also uncertain; hence, the reporting accountant has the option of providing an estimate of event after assessing the degree of likelihood of occurrence, and then recognises such in the accounts (IASB, 2001).

Furthermore, the advocates of accounting conservatism argued that where there is debt agreement, the borrower has the tendency of reporting on timely basis information that portrays the firm as internally efficient while the information that reveals the weakness of the firm are concealed resulting into information asymmetry between the lender and the borrower (Ruch & Taylor, 2015). The lender is disadvantaged in this case because the information about the brilliant performance of the borrower may not do well to the lender as much as information about the internal crisis experienced by the borrower. If the lender has the information about the internal problem faced by the borrower on timely basis, it enables the lender to take prompt action to protect his/her interest (Lara, Osma & Penalva, 2011). In other words, timely loss recognition enables lenders to assess the potential default risk, which may eventually make him decide to either, withdraw or not withdraw from the debt agreement depending on his/her risk appetite. The alleviation of asymmetric pay-off between the lender and borrower is the natural role played by accounting conservatism, and this is why some scholars advocate it. Similarly, it advocated that accounting conservatism equally benefits borrowers in the sense that lenders are willing to accept lower cost of capital if the borrowers provide information that enables them assess the default risk associated with their investments.

To the equity investors, it is documented that accounting conservatism benefits their investment decision in the sense that timely loss recognition when there is bad news provides useful information for the investors; thus, it is suggested that there is positive link between conservatism and information quality (Watts, 2003). Similarly, conservatism is said to reduce information asymmetry between the management of firms and the investors such that private information that is relevant in assessing the future cash flow of firms which may not be available to the investors are communicated to them through the application of accounting conservatism. In contrast, the costs of accounting conservatism are prevalent where preparers of financial statements recognise losses on a timely

basis when there is good news resulting in a weak association between accounting information and share prices. If there is probable gain and such is deferred, earnings do not provide useful information for investors' decisions (Xie, 2015). In addition, the practice of expensing research and development cost provides motivation for earnings management, which reduces accounting information quality. Apart from providing motivation for earnings management, expensing research and development cost and advertising cost instead of capitalising them introduces volatility into earnings streams; thus decreasing earnings persistence and earnings predictability of firms (Chen et al., 2014; Ruch & Taylor, 2015).

Finally, the effect of accounting conservatism in terms of its costs and benefits depends on whether it is a conditional conservatism or unconditional conservatism. Conditional conservatism is an accounting practice where bad news inform of probable losses are recognised in the books earlier than when there is good news inform of probable gains e.g the use of lower of cost and net book value in the recording of inventories, and impairment test on non-current assets. Contrarily, unconditional conservatism is not linked to any news but the continuous under-recognition of net asset by witting off the cost of research, advertising, and the use of accelerated depreciation (Bandyopadhyay et al., 2010).

Theoretical Review

The study adapted 'Ohlson Equity Valuation Model' to achieve its objectives. Ohlson propounded this theory in 1995 to establish a formal link between market value of shares and accounting information. Therefore, since this study examined the relationship between market value of equity and accounting information, this theory is suitable; hence, it the foundation upon which this study is built. Basically, the theory establishes a connection between abnormal earnings, book value of equity, and dividend (Durán Vázquez, Lorenzo Valdés, & Valencia Herrera, 2007). A further development of the theory shows that Ohlson (1995) admits information beyond abnormal earnings, book value of equity, and dividend. The work of Ohlson (1995) also begins with the assumption that firm value is equal to the present value of future expected dividend. Similarly, since investors' decision is connected to the cash flow effect of firm transactions, firm value is also the present value of future expected cash flow. Furthermore, the Ohlson model (1995) rests on the clean surplus relation. The clean surplus relation connotes that changes in book value of equity is equal to reported earnings minus dividend payments (Abogun, 2018). The clean surplus assumption is drawn from the capital maintenance concept of accounting. According to IASB (2010),

'under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period'.

The difference between the financial capital at the end of a particular period and financial capital at the beginning of the period after excluding dividend and additional issued capital is the profit earned for that period. The clean surplus

relation assumption posits that this profit is expected to be equal to reported profit (profit from profit or loss statement) minus dividend paid. It is the imposition of the clean surplus assumption on the residual income model that resulted into the Ohlson model (1995). Since the model admits other accounting constructs beyond earnings, book value, and dividend, this study examined the value relevance of accounting conservatism alongside other basic constructs of valuation model. It is based on the Ohlson model (1995) that, the empirical model of this study is developed; hence, this study is hinged on the theory.

Empirically, the influence of conservatism principle on the relevance of annual accounts is mixed and inconclusive (Xie, 2015). Chen, Folsom, Paek and Sami (2014) revealed that the earnings of firms that highly apply conservatism are less persistent relative to firms that less applies conservatism. Similarly, Bandyopadhyay, Chen, Huang, and Jha (2010) revealed that the more firms apply accounting conservatism in the preparation of accounts the less the decision usefulness of earnings. In the same vein, Balachandran and Mohanram (2011) found no evidence that firms with high application of accounting conservatism have greater value relevance of accounting information. On the contrary, Kordlouie, Mohammadi, Naghahineh and Tozandeyani (2014); Osundina and Olayinka (2017) posit that accounting conservatism has positive influence on the usefulness of financial reports for investment decisions amongst other things.

Methodology

The research design suitable for this study is the explanatory research design. This is considered suitable since this study examines changes in equity value explained by earnings, book value, dividend, and application of accounting conservatism. Consequently, data were obtained from the secondary sources particularly from the Nigerian stock exchange database and official website of each sampled company. The population of this study consists of 190 firms whose shares were traded on the floor of the Nigerian stock exchange. These firms were spread across eleven (11) sectors as classified by the Nigerian stock exchange. In order to select the sample, some requisite criteria were employed. Since the period covered in this study starts from 1996, then the firm, which has a chance of being selected, must be listed not later than 1996. Secondly, any firm to be included must not only be listed on or before 1996 but must remain listed. Due to these criteria, only eighty-six (86) firms satisfied the criteria and as such, the sampling frame consists of 86 firms. However, due to lack of readily available data, forty-six firms were selected using the stratified sampling technique. Furthermore, data were sourced across forty-six (46) firms for the period of twenty (20) years starting from 1996; hence, panel data were used in this study.

Model Specification

Following Ohlson (1995), the model of this study is specified as:

$$SP_{it} = \beta_0 + \beta_1 ENGS_{it} + \beta_2 BV_{it} + \beta_3 DIV_{it} + \beta_4 CSV_{it} + \beta_5 ENGS_{it} * CSV_{it} + \varphi_{it} \dots\dots\dots 1$$

Where EV is equity value measured using the market share price of each company; EPS represents earnings per share measured as total earnings divided by ordinary shares in issue; BV is book value of shares measured as net assets divided by ordinary shares in issue; DIV represents dividend per share measured by dividend distributable to ordinary shareholders divided by number of shares in issue; CSV represents accounting conservatism measured by ratio of book value of equity to market value of equity; EPS*CSV shows the interaction between earnings and application of accounting conservatism measured by the product of the two variables into one; while the symbol φ represent the stochastic error term.

In order to estimate the equation 1 specified above, the fixed effect panel estimation technique was employed. This is suitable because the study accounted for individual differences which could not be accounted for using the pooled ordinary least square.

Results

The descriptive statistics reported on Table 1 include mean value; standard deviation; minimum value and maximum value. The mean value of 24.12 and standard deviation of 46.98 revealed that the average share price of sampled firms is ₦24.12k. the size of the standard deviation shows that the share price is widely spread which might be due to the panel data used. In the case of earnings, as much as there are firms which reported huge profits there are those who reported low profits and in some cases losses. It is the same for book value of equity and dividend. In the case of conservatism, the average value of 0.77 tells that the difference between accounting measurement and market value of equity is not much, which shows that accounting conservatism was not applied much in preparing the financial statement. Consequently, equity value as measured by accounting systems provides as much information as valuation by the stock market.

Table 1 Descriptive Statistics

. summarize SP ENGS BV DIV CSV CSVENGS

| Variable | Obs | Mean | Std. Dev. | Min | Max |
|----------|-----|-----------|-----------|-----------|----------|
| SP | 792 | 24.15547 | 46.98231 | .39 | 419 |
| ENGS | 752 | 2058.673 | 10359.74 | -102400.4 | 118016 |
| BV | 705 | 7.925744 | 16.77534 | -43.18768 | 307.8425 |
| DIV | 710 | 1.268045 | 3.022197 | 0 | 27.5 |
| CSV | 795 | .77042 | 2.834191 | -45.46071 | 37.34781 |
| CSVENGS | 751 | -94.26915 | 13574.45 | -305274.8 | 28014.99 |

Authors' Computation, 2020

The result of Housman test is presented in Table 2. This test is carried out to choose between the random effect and fixed effect panel estimation techniques. It tests the suitability of either within estimators or between estimators. It further

seeks to test if the individual difference due to cross sectional units in the panel data is a fixed or random. The decision criterion is that the null hypothesis is rejected if the individual difference is statistically significant. If the null hypothesis is rejected, the fixed effect is more suitable than the random effect. The null hypothesis is stated as: difference in coefficient not systematic. The result in Table 2 shows that the null hypothesis is rejected since the reported p-value of 0.000 is less than the three conventional significance levels of 1%, 5%, and 10%. This implies that fixed effect is suitable for estimating the data than random effect; thus, the fixed effect was used in this study to estimate the model of this study.

Table 2 Hausman Test

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. hausman fe re
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| | —— Coefficients —— | | | |
|---------|--------------------|-----------|---------------------|-----------------------------|
| | (b) fe | (B) re | (b-B) Difference | sqrt(diag(V_b-V_B)) S.E. |
| ENGS | .0018522 | .0005105 | .0013417 | .0002177 |
| BV | .7263745 | .7403969 | -.0140224 | .0226202 |
| DIV | 7.850796 | 12.9567 | -5.105906 | .387392 |
| CSV | -1.507021 | -1.376561 | -.13046 | .1337676 |
| CSVENGS | -.0042907 | -.0019089 | -.0023819 | .0003845 |

b = consistent under Ho and Ha; obtained from xtreg
 B = inconsistent under Ha, efficient under Ho; obtained from xtreg

Test: Ho: difference in coefficients not systematic

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    chi2(5) = (b-B)' [(V_b-V_B)^(-1)] (b-B)
              =      201.14
    Prob>chi2 =      0.0000
    (V_b-V_B is not positive definite)
    
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Authors’ Computation, 2020

Table 3 presents the regression result estimated using the fixed effect estimation technique. From the same Table 3, it is shown that the dependent variable is share price while the independent variables are earnings, book value, dividend, accounting conservatism, and an interaction variable. The interaction is the multiplication of earnings by accounting conservatism. The essence of this interaction term is to examine the condition specified by accounting conservatism under which earnings influences equity value. It measures how accounting conservatism affects the relationship between earnings and share price. Since testing for relationship between accounting information (earnings, book value, dividend) and share price is used to measure value relevance accounting information, the interaction of earnings with conservatism in this case is used to measure how conservatism affect the value relevance of earnings. If the interactive term is significant then it can be concluded depending on the sign of the coefficient of the interaction term that the moderating variable (accounting conservatism in this case) has interactive effect on the value relevance of earnings.

Table 3 Regression Results

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. xtreg SP ENGS BV DIV CSV CSVENGs, fe

Fixed-effects (within) regression              Number of obs   =       654
Group variable: FirmID                       Number of groups =       46

R-sq:  within = 0.3505                       Obs per group:  min =       1
        between = 0.4923                       avg =      14.2
        overall = 0.5646                       max =       20

F(5, 603) = 65.08
corr(u_i, Xb) = 0.2719                       Prob > F = 0.0000
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| SP | Coef. | Std. Err. | t | P> t | [95% Conf. Interval] | |
|---------|---|-----------|-------|-------|----------------------|-----------|
| ENGS | .0018522 | .0002604 | 7.11 | 0.000 | .0013408 | .0023636 |
| BV | .7263745 | .0848776 | 8.56 | 0.000 | .559683 | .8930661 |
| DIV | 7.850796 | .6618683 | 11.86 | 0.000 | 6.550949 | 9.150643 |
| CSV | -1.507021 | .4100628 | -3.68 | 0.000 | -2.312345 | -.7016958 |
| CSVENGs | -.0042907 | .0007878 | -5.45 | 0.000 | -.0058379 | -.0027436 |
| _cons | 12.82091 | 1.34054 | 9.56 | 0.000 | 10.18822 | 15.4536 |
| sigma_u | 29.510053 | | | | | |
| sigma_e | 24.221996 | | | | | |
| rho | .59747126 (fraction of variance due to u_i) | | | | | |

F test that all u_i=0: F(45, 603) = 6.39 Prob > F = 0.0000

Authors’ Computation, 2020

From Table 3, it is shown that earnings, book value, and dividend have significant positive impact on share price with positive coefficients and p-values less than 1%. The coefficient of earnings of earnings is 0.002 with a p-value of 0.000. The coefficient of book value is 0.73 with a p-value of 0.000. Similarly, the coefficient of dividend is 7.9 with a p-value of 0.000. The positive significant coefficients of earnings, book value, and dividend indicate that they are value relevant. It means that as earnings, book value, and dividend increase, the more relevant information it conveys for pricing shares. On the other hand, the coefficients of accounting conservatism and the interactive term show significant negative relationships with coefficients of -1.51, -0.0042 and p-value 0.000 and 0.000 respectively. This implies that share price decreases as the application accounting conservatism in preparing financial statement increases. In the case of the interaction term, the negative sign of its coefficient and that of accounting conservatism shows that the value relevance of earnings decreases as accounting conservatism decreases. This results shows that accounting conservatism has moderating effect on the relationship between earnings and share price such that the value relevance of earnings increases as accounting conservatism increases.

Finally, from the same Table 3, three different values were reported for R-squared but the relevant among the three is R-squared within. This is because it has all the properties of R-squared from ordinary regression. The value of R-squared within as contained in Table 3 is 0.35. This value is considerably good based on value relevance literatures. Apart from measuring the global fitness of

the model, R-squared in this case measures the extent to which earnings, book value, dividend and conservatism are value relevant. Therefore, since the individual accounting information is significant and the R-squared is good, it is interpreted to mean that accounting information is value relevant in the face of accounting conservatism.

Discussion of Findings

The theory underpinning this study is the Ohlson (1995)'s model of equity valuation. The model establishes a link between equity value (share price) and accounting information, which includes but not limited to earnings, book value, and dividend. In addition to this, the study examined the moderating effect accounting conservatism on the relationship between equity values and accounting information. In line with the proposition of Ohlson (1995)'s model, this study found that earnings, book value, and dividend have positive impact on share price. In the same vein, the findings of this study confirms the findings of previous study that earnings, book value, and dividend are value relevant (Ball & Brown, 1968; Francis, Schipper, & Vincent, 2002; Oyerinde, 2011; Filip & Raffourner, 2010; Elshandidy, 2014). This is also in line with the findings of Ha, Ngoc Hung, and Tran (2018). This finding is also in conformity with the a-priori expectation of significant link between share price and accounting information.

Conclusion and Managerial Implication

In line with the findings, the study concludes that earnings, book value of equity, dividend, and accounting conservatism are value relevant. In the same vein, the study concludes that application of accounting conservatism in the preparation of financial statements has a moderating effect on the value relevance of accounting information.

The implication of this study is that management of firms should apply accounting conservatism in the preparation of financial statement since the result shows that value relevance of earnings decreases as accounting information decreases.

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