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# Value relevance of conservative and non-conservative accounting information

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## Abstract

The present paper examines effects of reporting conservatism on the value relevance of accounting earnings of a sample of Greek firms over the period from 1989 to 2003. The results of the paper indicate that conservatism is a salient feature of the Greek Accounting System. Moreover, the results depict that the level of conservatism has increased after the market crisis of 1999, potentially as a result of the additional regulation, imposed by the market authorities during the post-crisis period. Finally, the results show that there is a non-linear association between conservative reporting and value relevance of earnings. In particular, value relevance increases when moving from low-conservative firms to medium-conservative firms and decreases when moving further to high-conservative firms. Overall, the results of the paper lend empirical support to the theoretical underpinnings of Watts (2003a) who, on the one hand, report a number of arguments in favor of conservatism but, on the other hand, questions the practice of excessive conservative reporting as being a potential cause of the distortion of the earnings-returns relation.

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## 1. Introduction

The interest in the association between the value relevance of accounting earnings and the degree of reporting conservatism has increased in line with two distinct but not unrelated research paths: (a) the research on the value relevance of accounting earnings and

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earnings yields; and (b) the research on the level of reporting conservatism and its prevailing effects.

In particular, the first path of research has revealed, among other things, that over the past forty years the information content of accounting earnings (or yields) for stock prices (or returns) exhibits a declining trend pattern (Collins, Mayde & Weiss, 1997; Lev & Zarowin, 1999; Francis & Shipper, 1999). The second path of research has revealed that, over the same period of time, reporting in the United States and several other countries displays a gradual increase in the level of conservatism (Givoly & Hayn, 2000; Holthausen & Watts, 2001 for the U.S.; Grambovas, Giner, & Christodoulou, 2006 for EU countries; Bushman & Piotroski, 2006 for several countries all over the world).

Although an observable implication of these results is that conservative reporting is a potential cause for the decline in the value relevance of earnings, the existing research on a direct link between conservatism and value relevance is scarce and offers contradictory results. For example, Balachandran and Mohanram (2006) observe that the information content of conservatively reported earnings for stock returns exceeds that of non-conservatively reported earnings and conclude that reporting conservatism is unlikely to be the primary cause for the declining value relevance of accounting earnings. On the other hand, Watts (2003b) lends conceptual support to such findings in the area, by arguing that conservatism in accounting alleviates potential measurement errors which cause lack of reliability of accounting information. The lack of reliability limits the usefulness of decisions made by investors and therefore the effect of conservatism is to increase rather than to decrease the value relevance of earnings.

The present paper uses data from an unbalanced-panel sample of Greek firms listed on the Athens Stock Exchange (ASE) over the period from 1989 to 2003 and expands on prior research in a threefold manner. First, in contrast to prior studies in the area, the present paper uses an improved methodological framework, which accommodates the effects of cross-sectional dependence in the data and attempts to provide an unbiased answer to the question of whether the information content of earnings for stock returns in Greece has declined over time. Second, under a similar methodological framework, the paper gauges the level of reporting conservatism in Greece over the period 1989 to 2003. Finally, it combines the results of the aforementioned research questions and sheds light on the effects of conservatism on the value relevance of accounting information over the same period.

For the purposes of the present paper, conservatism is defined as the asymmetric way in which good and bad news are recognized in earnings (Basu, 1997; Pope & Walker, 1999) and is quantified using a measure of conservatism that stems from the Basu (1997) model of conservatism. On the other hand, the value relevance of accounting earnings is defined as the ability of earnings to explain market returns (Francis & Schipper, 1999) and is assessed using the two methods proposed by these authors; (a) the magnitude of the adjusted  $R^2$  of the Easton and Harris (1991) model; and (b) the magnitude and sign of the returns of a hedge portfolio, which is formed by ranking sample firms according to their conservatism measure and then by taking a long position on the top 30% and a short position on the lower 30% of the ranked sample firms.

In a final illustration, the present paper investigates whether new regulation that induces conservatism in financial reporting practices has a bearing on the results of the present paper. While the Greek Accounting System is considered to be conservative by nature

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