Relations between Unconditional and Conditional Accounting Conservatism with Bankruptcy Risk in Companies Listed in Tehran Stock Exchange

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ABSTRACT: There are several theory and empirical evidence about the informational role of accounting conservatism and its desired impacts in the interests of providers of Corporate Capital Suppliers. The main objective of this study is examining the relationship between conservatism conditional and unconditioned with Bankruptcy Risk in Companies Listed in Stock Exchange. The study sample includes 157 listed companies is part of the data in the years 2005 to 2011 were analyzed. Results showed that the risk of bankruptcy has no significant effect on conditional conservatism. While this is inconsistent with the theoretical principles of research, conservatism reduces the risk of bankruptcy is unconditioned among the sample companies. Results also showed that conservatism unconditioned reduces the risk of bankruptcy. This finding was consistent with theory and research suggests the benefits of accounting conservatism to protect owners’ interests in the company are facing bankruptcy.

Keywords: Conditional conservatism; unconditional conservatism; Bankruptcy risk

INTRODUCTION

Conservatism is defined as higher pessimism to identify the profits compared to the losses. This leads into the rapid identification of losses compared to profits and the result is reduction in net assets value. The existence of conservatism procedures in financial reporting in response to the demand for this information is done to solve agency issues (Watts, 2003). Basu (1997) defined conservatism as the followings:

Conservatism is defined as the differential verifiability required for recognition of profits versus losses underestimating the gains and assets.

This definitions shows conditional conservatism. In recent studies conservatism is divided into two types: the first one is unconditional conservatism independent from News, unconditional conservatism is raised from using the accounting standards reducing the profit independent from current economical news. For example, immediate identification of advertisements costs and research and development as costs even the future cash flows are positive (Ball, 2004). The other one is post event conservatism based on News, conditional conservatism and Asymmetric Timely Earning. Conditional conservatism means timely recognition of bad News to good News in profit. For example the minimum fixed price or market value means deleting ownership after the test of reducing the value and asymmetrical recognition of losses vs probable profits. (Previous source).

Accounting conservatism increases available cash via increasing the input flows of cash and reducing the output of cash flow. Conservatism increases cash flows via conservatism saving, reducing capital cost and increasing operational cash flow (Bidel et al. 2011). Ahmad and Dulman (2002), Lara et al (2010); and Li (2010) proved that conservatism via limiting extreme investing and increasing operational cash flow reduces capital cost and facilitates financing out of organization and leads into rapid access of the company to cash financial resources.

Lara et al. (2010) stated that conservatism increases management motivations to avoid investment in the projects with negative net current value and ignoring loss projects. Bushman et al. (2010) found that timely
Identification helps the manager with timely recognition of loss projects. Thus, the role of conservatism in increasing the cash flow reduces bankruptcy risk. As based on financial evidences, bankruptcy is the condition in which the kept cash is not suitable to meet the necessary demands. In other words, to pay the debts and obligations, the cash resources are needed and in case of the lack of inadequacy of resources, the company goes bankruptcy (Biddle et al. 2011). According to above theoretical and empirical evidences, we can expect that accounting conservatism (conditional and unconditional) affects bankruptcy by three ways. 1) The role of accounting conservatism in increasing the cash keeping level (as conservatism cash) causes to have suitable financial resources and is faced with low bankruptcy. 2) Conservatism due to underestimating profit and assets and restriction of payment to the providers of capital and facilitating in financing outside of the company, reduced the bankruptcy risk of loss companies and delayed their bankruptcy. 3) Conservatism procedures lead into rapid identification of bad News and loss projects and reduce the bankruptcy of the firm (Biddle et al. 2011).

If accounting conservatism (conditional and unconditional) affects bankruptcy risk, it is possible that bankruptcy is a factor to use conservatism procedures in financial reporting. In other words, it seems that in the firms in which future bankruptcy is seen more, more conservatism is applied and this is due to demand and supervision of providers of company capital on its reporting environment. In the current study, to determine the good nature of accounting conservatism for the firms in which some signs of bankruptcy is seen and the tendency of capital providers of the firs to apply more conservatism is the mutual relation between conditional and unconditional conservatism with bankruptcy risk.

**Informational role of conservatism**

The managers are potentially motivated to show the company condition good and due to the power of manager in giving financial reports, they have the opportunity to apply this procedure. Thus, the existence of supervision and control mechanisms to keep the benefits of shareholders is necessary (Givoly, D. and C. Hayn, 2000). The evidences show that conditional and unconditional conservatism reduces information asymmetry and the lack of reliability in information. This conservatism function is arising from pessimistic view to unfulfilled incomes and rapid and timely identification of bad News (Watts, 2003; Li, 2010). In most of the previous researches, good effects of accounting conservatism on financial reporting environment is proved to keep shareholders benefits and credit givers (Bushman et al.(2010); Lara et al. (2010)).

**The role of conservatism in bankruptcy firms**

The managers can hide bad News of the firm and it seems that negative information inside a company is stored. A restriction for the managers in terms of bad News they can absorb and hide successfully. This restriction is due to the fact that if at a special time, Bad News gathered reaches a threshold or definite limit, hiding them is costly or is impossible. When collecting bad News reaches the final point, they are scattered suddenly and lead into the bankruptcy of the firm (Jin, L., Myers, C.S,2006; Hutton, A.Pet al(2009)).

It seems that a conservatism procedure in financial reporting of bankruptcy firms is necessary. Because, at first in these firms the bad News is more compared to other companies and the managers try to attempt more to hid bad News. Second, the necessity of keeping financial resources of firm is increased via underestimating the profit and assets. Also, conservatism of taking out cash is fulfilled via avoiding unnecessary cash costs, delay in paying fulfilled costs and reducing agency costs related to keeping cash. Here, conservatism via late identification of profits and increase of assets, taking out cash in the form of reward reduces tax or dividend profit (Biddle, 1980; Watts,2003; Callen, 2010).

**Review of literature**

Jin, L., Myers, C.S (2006) developed a model in which vague information create a series of individual factors as integrated and they have the opportunity to hid bad News. When bad News are scattered outside, the negative outcomes of stock return or sudden drop of stock price is observed. By national and company data, Jin, L., Myers, C.S(2006) and Huton et al.(2009) provided some evidences for higher predictions.

Kothari et al. (2009) provided some evidences suggesting that the managers are inclined to delay bad News for foreign investors. The management inclination to hid bad News from foreign investors creates falling risk or negative return skewness. This is due to the fact that asymmetrical thinking of the managers leads into inside company storing of bad information and transferring them to foreign investors (Kothari, S. P., Ramanna, K. and Skinner, D. J, 2009).
Srivastava, A., Tse, S.Y (2009) found that timely recognition of losses increases this probability that the firms can stop unsuitable projects at a good condition. Thus, Francis and Martin (2010) found that conservatism companies act more rapidly in stopping the unsuitable companies compared to other companies. Beatty, A., J. Weber and J.J. Yu (2008) studied conservatism conditions in debt contracts. They found that when debt agency costs are higher, these contract conditions are used more. Their evidences showed that contracting conditions don't fulfill the demand of credit givers for conservatism. Thus, to reduce debt agency costs, we should use conservatism accounting. Hui, K. W., Morse, D. and Matsunaga, S (2009) found that conservatism causes that the firm can conclude the contracts with good conditions with the raw materials sellers and this leads into the increase of operational cash flow. Generally, both conditional and unconditional conservatism reduce the risk of decreasing operational cash flow.

Kirschenheiter and Ramakrishnan (2010) found that cautious decision makers to reduce the risk of future inflow cash try to have accounting conservatism to take decision easily about conservatism cash flows and increases up keeping of cash flow (Biddle et al. 2011).

Biddle et al. (2011) in a study performed titled “Accounting conservatism and bankruptcy risk found that conditional and unconditional conservatism via increasing cash flows and information clarity reduced the bankruptcy risk in the firms. This study proposes that when bankruptcy is increased, the demand of providers of company capital and auditors is increased to apply more conservatism in financial reporting.

Rezazadeh and Azad (2008) determined the relation between information asymmetry between the investors and conservatism in financial reporting. They used the proposed price difference of stock exchange and Basu criterion to measure information asymmetry and conservatism. The results of the study showed positive and significant relation between the information asymmetry between the investors and conservatism in financial statements. Also, the results showed that the change of information asymmetry between the investors changed the conservatism.

**Theoretical framework**

Generally, the companies facing financial crisis, supervision mechanisms are applied from capital providers carefully and auditing operation is followed with more sensitivity. It seems that managers are obliged to do unconditional conservatism because the lack of applying them leads into discipline costs for managers as losing job or fame. While opportunistic motivations of managers for reporting is contradictory and hiding bad News in bankruptcy companies is more than other companies (Kutari et al. 2010). It seems that in financial crisis conditions and powerful systems of such conditions, the managers are inclined to conditional conservatism. While capital providers of the company and auditors followed unconditional conservatism. It seems that both conditional and unconditional conservatism are more in the companies with high bankruptcy risk. Thus, the first and second hypotheses are raised as:

**First hypothesis**
Bankruptcy risk increases conditional conservatism

**Second hypothesis**
Bankruptcy risk increases unconditional conservatism.

Based on the issues in study problem and previous studies, we can say that accounting conservatism (conditional and unconditional) can have important role in reducing bankruptcy risk. Thus, third and fourth hypotheses are raised as:

**Third hypothesis**
Conditional conservatism reduces the bankruptcy risk

**Fourth hypothesis**
Unconditional conservatism reduces bankruptcy risk

**Research method**
This study is applied in terms of objective and is descriptive in terms of method and correlation. In this study, the variables were classified into independent and dependent groups and the mutual relation between them was investigated via regression tests. The current study is expose facto study. Because historical data were used to test hypothesis. The current study is descriptive in terms of collection method and the data of statistical samples are used to test the hypotheses by library method.

**Study population**
The study populations of the study were all the companies listed in TSE except investment companies, insurance and banks with the following conditions.
1) in financial years 2005 to 2010 were present in stock exchange.
2) The end of their fiscal year was the end of Esfand each year and along the mentioned period, there was no change in fiscal year.
3) The exchange symbol of the active company and more than 4 months per year didn't have exchange symbol.
The study period was from 2005 to 2010 for six years. The sampling was elimination systematic sampling and based on the above considerations, 157 companies were selected of Study Company.

**Study variables and calculating method**
The main variables of the current study are conditional and unconditional conservatism and bankruptcy and the estimation method of each of them is as:

**Bankruptcy estimation method**
In the current study to measure the bankruptcy risk, Altman model (1968) was used. Altman (1968) via analysis of multiple recognition and 22 financial ratios selected five rations as combined as the best predicting factors of bankruptcy. The reason of using this method is such that Altman model is one of bankruptcy models being proved many times in local studies and predicting power in Iran economical conditions (e.g. Qodrati and MaenaviMoqadam researches, 2009 and Soleimani, 2010). Altman model is as follows (Soleimani,2010).

$$Z = 0.999X_1 + 0.6X_2 + 3/3X_3 + 1/4X_4 + 1/2X_5$$

Predicting variables (Xs) in the above model were sale to sum of assets, shareholders equity value to debts book value, profit before interest and tax to the sum of assets, accumulated profit to the assets sum and flow capital to the sum of assets. Altman after testing the evaluation model found that its success ratio was 95% (ibid).

In the above model, z was used as Altman bankruptcy index and is calculated for each year seperately. The bigger the size of z, the less the bankruptcy risk of the company. As in research hypothesis model, bankruptcy risk is considered, the achieved value for z is multiplied by (-1). Bankruptcy risk in hypothesis test is shown with BR symbol.

**Measuring unconditional conservatism**
Unconditional conservatism is a type of conservatism affected by accounting standards and legal requirements. To evaluate this variable, we calculate total accruals to total assets. The negative items showed high degree of conservatism because the result of unconditional conservatism is underestimating profit and the reported profit is lower than cash flows of the company (Givoly, D. and C. Hayn, 2000; Ahmad and Dulman, 2007).

$$UC-ACC = \frac{TACC_{i,t}}{TA_{i,t}} (-1)$$

TACC: Total accruals
TA: Book value of total assets
The total accruals are computed as:
Total accruals = net income before extraordinary items + operational cash flow
Measuring conditional conservatism
Conditional conservatism is arising from management reporting and asymmetrical reaction against recognition of losses and unfulfilled profits (Basu, 1997). To measure conditional conservatism, we used non-operational accruals. According to Jang (2008) bad News of the company is reflected in non-operational accruals. The calculation method of this variable is as:

$$CC-ACM = \frac{NACC_{i,t}}{TA_{i,t}} (-1) \frac{NACC_{i,t}}{TA_{i,t}} (-1)$$

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NACC: Non-operational accruals
TA: Book value of total assets
Non-operating accruals are calculated as:
Nonoperating accruals = Total accruals - Δaccounts receivable
-Δinventories-Δprepaidexpenses+Δaccounts payable
+Δtaxes payable

**Hypotheses test**

To test the hypotheses of this study, the following models were fitted. These regression models were presented by Biddell et al. (2011).

Model (1)
\[ CC_{ACM_t} = \beta_0 + \beta_1 BR_t + \beta_2 BR_{t-1} + \beta_3 UC_{ACC_{t-1}} + \beta_4 CC_{ACM_{t-1}} + \beta_5 Leverage_t + \beta_6 BM_t + \beta_7 ROA_t + \beta_8 LnMV_t + \beta_9 Size_t + \varepsilon_t \]

Model (2)
\[ UC_{ACC_t} = \beta_0 + \beta_1 BR_t + \beta_2 BR_{t-1} + \beta_3 UC_{ACC_{t-1}} + \beta_4 CC_{ACM_{t-1}} + \beta_5 Leverage_t + \beta_6 BM_t + \beta_7 ROA_t + \beta_8 LnMV_t + \beta_9 Size_t + \varepsilon_t \]

Model (3)
\[ BR_t = \beta_0 + \beta_1 CC_{ACM_t} + \beta_2 BR_{t-1} + \beta_3 UC_{ACC_t} + \beta_4 CC_{ACM_t} + \beta_5 Leverage_t + \beta_6 LnMV_t + \beta_7 Size_t + \beta_8 ROA_t + \beta_9 Casht + \beta_{10} \Delta Caasht + \varepsilon_t \]

Model (4)
\[ BR_t = \beta_0 + \beta_1 UC_{ACC_t} + \beta_2 BR_{t-1} + \beta_3 UC_{ACC_t} + \beta_4 CC_{ACM_t} + \beta_5 Leverage_t + \beta_6 LnMV_t + \beta_7 Size_t + \beta_8 ROA_t + \beta_9 Casht + \beta_{10} \Delta Caasht + \varepsilon_t \]

Where UC_{ACCt} is non-conditional level, CC_{ACM}: Conditional conservatism level, BR: Bankruptcy risk, Leverage: The leverage of company as control variable (the ratio of total debts to total assets), BM: the ratio of book value to market value as control variable, ROA: Assets ratio as control variable (The ratio of net profit to total assets), LnMV: Natural logarithm of stock market value as control variable, Size: The size of company as control variable (Natural logarithm of company assets).

**The results of first hypothesis test**

The first hypothesis is about the effect of bankruptcy risk on conditional conservatism and there is a direct relation between these two variables. To test this hypothesis, a regression model in which conditional conservatism level is dependent upon bankruptcy risk other control variables are used. To fit regress models of the hypotheses of this study, step wise model was used. Step wise method in regression is a method in which study software adds independent variables one after another to the model and in each stage, the variables that are invalid are eliminated of the model. Finally, the most meaningful variables are presented in the form of a valid regression model based on decision making about the relation between independent and dependent variables and hypotheses. The results of fitting of the regression model are shown in Table 1.

After model fitting, it was defined that four above variables, were significant statistically and were kept in regression by step wise method. Other variables due to the lack of significance were eliminated of the model. Based on the results, the determination coefficient of regression model of sub-hypothesis 1 was 0.052 and it showed that this model determined only 5.2% of the changes in conditional conservatism via the changes of independent and control variables. Durbin-Watson statistics is an index to investigate the lack of self-correlation between the residuals of regression model.

Good level of Durbin –Watson statistics is used to investigate the lack of self-correlation between residuals of regression model.

Good level of Durbin-Watson statistics was between 1.5 to 2.5. As it is shown in the results, the lack of self-correlation between the residuals is established as one of the initial regression hypotheses about both models. One of the main analyses about regression is investigating the total significance of the model. This analysis is necessary as it shows the significant relation or insignificant relation between the independent and dependent variables of regression model. The required criteria for decision making is statistics F. statistical hypotheses about regression model are:

H0: \( \beta_i=0 \) Regression model is not significant
H1: \( \beta_i\neq0 \) Regression model is significant
Statistics F significance level is less than error (α=0.05) and H0 is rejected and it can be concluded that at least one of β coefficients are significant in fitted model. The second section of Table 1 shows the results of study analysis for independent variables coefficients in regression models. These results show the severity and significance of the relation of each of independent variables of regression model with dependent variable. The results show that bankruptcy risk variable as the basis of decision making in this hypothesis, due to invalid basis is eliminated of the model and the ratios are relate to control variables. The estimated variable for UC_ACCt-1 is positive and significant and variable coefficient CC_ACMt-1 is negative and significant. This finding shows that condition conservatism of current period has direct relation with unconditional conservatism of the previous period and inverse relation with previous period conditional conservatism. The estimated ratios for book value variables to market value and assets ratio was negative and significant. Thus, we can say that the firms with high book value and more ratio of assets, has less conservatism procedures in financial reporting. Based on the above evidences, we can not accept the claim accepted in first hypothesis based on the effect of bankruptcy risk on conditional conservatism and first hypothesis is rejected.

The results of second hypothesis test

In the second hypothesis, it is predicted that bankruptcy risk increased unconditional conservatism. In Table 2, the results of fitting of this regression model are shown.

Based on the results, the estimated determination coefficient of regression model was 0.17 and this model determined 17% of changes in unconditional conservatism via independent variables and control variables. Durbin-Watson statistics show that there was no self-correlation between the model residuals. Significance level of statistics F was less than test error (α=0.05) and it can be said that at least one of the coefficients of β is significant in fitted model. The results show that estimated coefficient for bankruptcy risk was -0.154 and its significance level were 0.002.

This finding showed a reverse and significant relation between bankruptcy risks with unconditional conservatism. In other words, the firms being less or more exposed to bankruptcy risk had less or more conservatism procedures in financial reports. This finding is not in line with the theoretical basics in second hypothesis. Because it seemed that risk and bankruptcy increased the motivation of sample companies to apply conservatism procedures in financial reporting. The estimated coefficients for control variables were similar to the results of first hypothesis test. Thus, book value ratio to market value and assets return had inverse and significant relation with unconditional conservatism and there was a direct relation between unconditional conservatism of the previous period and unconditional conservatism of current period. In sum, based on the above evidences, we cannot accept the claim in second hypothesis regarding the fact that bankruptcy risk increased unconditional conservatism and this hypothesis is rejected.

The results of third hypothesis test

In the third hypothesis, it was predicted that conditional conservatism reduced bankruptcy risk. Regression model fitting of this hypothesis was done by stepwise method. The results of fitting of this regression model are shown in Table 3.

After the model fitting, it was defined that above variables were significant statistically and were kept in regression by stepwise method. Other variables were eliminated of the model due to insignificance. Based on the results, the determination coefficient of regression model was 0.77. This model determined 77% of the changes in bankruptcy risk via the changes of independent and control variables. Durbin-Watson statistics was between 1.5 to 2.5 and showed that there was no self-correlation between the model residuals. Significance level of F statistics was less than test error (α=0.05). It can be said that at least one of β coefficients was significant in fitted model. The results showed that variable CC_ACM was eliminated of the model due to insignificance. While estimated ratio for CC_ACMt-1 was 0.05 with significance level 0.024 and it showed that conditional conservatism of previous period, increased the bankruptcy risk of the current period. This finding is not in line with third hypothesis. The coefficient for variable UC_ACCt-1 was negative and significant and showed a reverse relation between unconditional conservatism of the previous period and bankruptcy risk. The estimated coefficients for control variables showed that there was inverse and significant relation between bankruptcy risk and assets return and cash. In other words, the firms with good and high cash flow less are gone bankruptcy. Also, according to the findings presented in Table 3, there was direct and significant relation between bankruptcy risk and financial leverage and book value ratio to market value and it showed that the firms their investment is relied on financing.
out of the company and the companies with less company value go bankruptcy more. As conditional conservatism as the basis of decision making about third hypothesis is eliminated due to insignificance and we can not accept the claim in this hypothesis and this hypothesis is rejected.

The results of fourth hypothesis test

In fourth hypothesis, it was predicted that unconditional conservatism reduced bankruptcy risk. Regression model fitting of this hypothesis was done by stepwise method. The results of fitting this regression model are shown in Table 4.

The estimated coefficient for UC_ACC<sub>t</sub> variable is 0.034 with significance level 0.048. This finding shows a reverse and significant relation between bankruptcy risk and unconditional conservatism and it is based on fourth hypothesis. The results of control variables coefficients were similar to the results of third hypothesis test and it showed that bankruptcy risk has inverse relation with cash residual and assets return and has direct relation with financial leverage of the company.

Based on the above evidence, we can say that by increasing (reducing) unconditional conservatism in sample firms, their bankruptcy risk is increased (reduce) and the fourth hypothesis and the claim is accepted at confidence level 95%.

DISCUSSION AND CONCLUSION

In the current study, the mutual relation between conditional conservatism and unconditional conservatism and bankruptcy risk was investigated. The results of study analysis showed that bankruptcy risk had no significant effect on conditional conservatism. While this is in contradiction with the theoretical basics of the study and bankruptcy risk reduced unconditional conservatism among the sample companies. While it reduced unconditional conservatism. As conservatism reduced net profit and assets value, it seems that the managers of the companies exposed to bankruptcy try by restricting the conservatism procedures show the company condition god and hid the bad News of the company. This result shows that the supervision role of shareholders is not fulfilled among the capital market companies and they couldn't avoid benefit actions of the managers in financial reporting of bankruptcy companies. The results showed that unconditional conservatism reduced bankruptcy risk. This finding was in line with the theoretical basics of the study and showed the benefits of accounting conservatism to keep the benefits of owners in bankruptcy companies. In sum, the above findings include some key concepts regarding the information and supervision role of accounting conservatism. First, bankruptcy signs can not be a reason for the demand of providers of the capital of the companies to apply more conservative procedures. Second, the above findings were in line with previous theoretical and empirical evidences regarding the good role of conservatism in financial reporting system (e.g Jang studies, 2008 and Huy et al.2009) and it shows that accounting conservatism helps the financial clarity and keeping the benefits of capital providers. Finally, the asymmetrical effect of conditional and unconditional conservatism on bankruptcy risk show that the managers of sample firms had no inclination to apply conservatism procedures in financial reporting. Only a part of unconditional conservatism out of the power of managers is applied in financial reporting of the companies.

Research suggestions

Based on the findings of test, the recommended hypotheses are as: 1) It is recommended to the capital providers of partnership companies to improve their supervision tools to control the benefit motivations of the managers namely about bankruptcy companies and demand more conservatism in financial reporting of these companies. 2) It is recommended to the formulators of accounting standards and company rules to consider in the formulation of financial reporting systems, the support of benefits of partnership companies investment. 3) It is recommended to the managers of the companies with some signs of bankruptcy risk that by applying more conservatism in financial reporting help to keep the benefits of company and its owners against the outcomes of these signs.
Table 1. The results of study analysis of first hypothesis

<table>
<thead>
<tr>
<th>Variable</th>
<th>β Standardized</th>
<th>T statistics</th>
<th>Significance level</th>
</tr>
</thead>
<tbody>
<tr>
<td>UC_ACC,1</td>
<td>0.186</td>
<td>4.117</td>
<td>0.000</td>
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<tr>
<td>CC_ACM,1</td>
<td>-0.138</td>
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<td>0.002</td>
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<td>ROA</td>
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Table 2. The results of study analysis of second hypothesis test

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</thead>
<tbody>
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<tr>
<td>UC_ACC,1</td>
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<td>ROA</td>
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Table 3. The results of statistical analysis of third hypothesis test

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<td>Lev</td>
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<td>0.000</td>
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<tr>
<td>Cash</td>
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<td>-0.269</td>
<td>0.023</td>
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Table 4. The results of study analysis of fourth hypothesis

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<td>Cash</td>
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<td>-2.288</td>
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