

The effect of conditional and unconditional conservatism on earnings persistence

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ABSTRACT

Financial analysts and investors do not consider accounting earnings figures as the only determining indicator in determining future cash flows, but for them, the stability and repeatability of reported earnings are very important. Therefore, this study has examined the effect of conditional and unconditional conservatism on the earnings persistence of companies listed on the Tehran Stock Exchange during the period from 2007 to 2016. The research hypotheses have been tested using regression models and using panel data. For conditional conservatism, the Ball and Shivakumar model has been used, and unconditional conservatism has been calculated based on non-operating accruals multiplied by negative. The results of the hypothesis test showed that none of the conservatism criteria have a significant effect on earnings persistence.

Keywords: Conditional conservatism, Unconditional conservatism, earnings persistence

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INTRODUCTION

Conservatism is a characteristic of financial reporting that has long been associated with accounting theory and practice. Several definitions of conservatism have been proposed in the accounting literature. Some define conservatism as the choice of an accounting policy under conditions of uncertainty that ultimately results in the understatement of assets and income and has the least positive effect on shareholders' equity. Others define conservatism as the tendency of accountants to recognize and delay earnings and to undervalue assets (Mashayekhi, et.al 2009).

There are two completely different views on conservatism. Some researchers consider conservatism useful for users and analysts of financial statements and attribute an informational role to it. Some other researchers not only do not attribute an informational role to it, but also consider it to the detriment of preparers and users of financial statements and believe that conservatism reduces the quality of information (Khajavi, et.al 2010).

Conservative presentation of financial statements leads to some undesirable results for evaluation purposes. One of these is the incorrect matching of revenues and expenses, which causes the components of income to be temporary. Therefore, adopting conservative accounting methods causes income to be less stable than if less conservatism is applied (Ghaemi, et.al 2012).

Forecasting earnings for several future periods is one of the important goals of external users of financial information. On the other hand, reported earnings are one of the important criteria for determining the expected return of investors. In addition to the fact that the reported earnings figure is important for investors, the qualitative characteristics of earnings are also one of the dimensions of earnings information of particular interest to investors. One

of the qualitative characteristics of earnings is earnings persistence. Financial analysts and investors do not pay attention to the accounting earnings figure as the only determining indicator in determining future cash flows, but for them the persistence and repeatability of reported earnings are very important. They pay more attention to its constituent items than the final earnings figure (Khajavi, et.al 2010).

Considering the criticism made about the effect of conservatism on earnings volatility and considering that earnings persistence is one of the qualitative characteristics of earnings, the aim of this study is to investigate the effect of conservatism on earnings persistence. Also, this study helps to further explain the effects of conservative accounting in financial reporting by documenting the effects of conditional and unconditional conservatism on earnings persistence. On the other hand, the results of research on the effect of conservatism on earnings persistence are different. The results of some research showed that companies with a higher degree of conservatism have more stable earnings. On the other hand, some studies showed that conservatism has a negative effect on earnings persistence. These contradictory findings and diverse results indicate that conservatism in accounting is controversial (Nguyen, et.al 2025). Therefore, it is necessary to investigate the effect of accounting conservatism on earnings persistence in a developing market such as the Tehran Stock Exchange.

Literature review and theoretical foundations

Conservatism in financial reporting

Conservatism in accounting is the tendency and inclination to use a higher level of confirmation to identify favorable news compared to unfavorable news. Some researchers consider the reason for the existence of conservatism, which is caused by uncertainty, to be in two factors: the continuity of the business entity's activity in the foreseeable future and the requirement to estimate or estimate some amounts. They

also listed reasons for the use of conservatism; including that the pessimism resulting from the principle of conservatism in the financial reporting process causes the adjustment of the optimism of the main estimates of management about the performance of the business entity. Another group of researchers defines conservatism as the requirement to have a high degree of confirmation to recognize good news such as earnings versus recognizing bad news such as loss. This definition describes conservatism from the perspective of earnings and loss; while another definition defines conservatism from the perspective of the balance sheet. According to this view, in cases where there is real doubt in the choice or several reporting methods are considered, the method that has the least desirable effect on equity should be chosen. The third definition of conservatism is based on a combined earnings and loss and balance sheet perspective, in which conservatism means reducing reported retained earnings by recognizing income later and recognizing expenses sooner, which leads to undervaluation of assets and overvaluation of liabilities (Etemadi, et.al 2017). Another classification of conservatism has been made in the literature under the title of conditional and unconditional conservatism. According to Bal and Shivakumar (2005), conditional conservatism means the use of accounting policies and procedures that recognize bad news more than good news at a given time. While unconditional conservatism means the adoption of accounting policies and procedures that reduce earnings and the book value of net assets independently of economic news (Badiei, et.al 2014).

There have also been criticisms of conservatism by groups such as capital market activists, standard setters, and academic researchers. One of these criticisms is related to the disproportionate behavior of conservative accounting in recognizing income and losses; because the failure to recognize current earnings due to underrecognizing net assets leads to the recognition of earnings in periods that are not related to that period. On the other hand, some researchers, by comparing the cost method with the lower of cost and market price method, point out that underrecognizing assets in the current period will cause additional income to be recognized in subsequent periods. Sterling believes that conservatism leads to the negation of accounting principles because whenever conservatism conflicts with an accounting principle, it prevails over it. For example, the historical cost principle (versus the lower of cost or market), revenue recognition based on sales (versus the installment basis of revenue recognition), the matching principle (versus considering the expenses of research and development as expenses), the consistency principle (versus the change from cost to the lower of cost or market), and the disclosure principle (versus the understatement of assets). Despite such criticisms, proponents of conservatism argue that conservatism is still followed in practice. This is because years of experience have shown accountants that conservatism is a prudent and useful convention in an environment full of uncertainty. They argue that managers and owners naturally tend to be overly optimistic about a business entity. They see conservatism as a necessary antidote to this over-optimism (Bolo, et.al 2014).

Earnings quality in financial reporting

Earnings quality is a concept that has different aspects, and therefore, numerous definitions and different measurement

criteria have been proposed in relation to it. One of these criteria that has been emphasized in research is earnings persistence. Earnings persistence is one of the qualitative characteristics of accounting earnings, which can be measured in accounting information. Earnings persistence is an indicator that helps investors evaluate the company's future earnings and cash flows. Investors give more importance to the sustainable part of earnings than to its unstable part in estimating their future earnings and expected cash flows (Khajavi, et.al 2010). Given that earnings persistence as an indicator of earnings quality helps users of financial statements in their valuation decisions of the company, it is therefore important to examine whether conservative reporting affects earnings persistence (Chen, et.al 2014).

Conservatism has been considered in research from two aspects, conditional and unconditional. Given that the conditions of occurrence of conditional and unconditional conservatism are different, their impact on earnings persistence is different. Conditional conservatism is used in specific conditions, and that is when there are non-repeating bad news events that should be reflected in earnings. Therefore, the use of conditional conservatism in bad news periods leads to a decrease in earnings persistence. On the other hand, unconditional conservatism does not depend on events and is predictable and occurs regardless of events. Therefore, due to the predictability of unconditional conservatism in each period, it makes earnings more stable. Therefore, conditional conservatism leads to less earnings persistence than unconditional conservatism (Chen, et.al 2014).

Stakeholder theory and agency theory are two theories that can explain the effect of conservatism on earnings persistence. The results of the studies show that aligning with the stakeholder theory to increase the value and credibility of the company in order to maintain long-term relationships with stakeholder leads to the presentation of high-quality earnings reports and also observes a higher level of conservative reporting. Therefore, the stakeholder theory is a suitable basis for explaining the effect of conservatism on earnings persistence. The agency theory is based on the relationship between managers and owners. Given the conflict of interest between managers and owners, contracts should be concluded in which the need to use conservative reporting to measure management performance should be considered. On the other hand, publishing quality financial statements, of which accounting conservatism is one of the basic principles, leads to better management performance under the supervision of owners. On the other hand, one of the dimensions of financial statement quality is earnings quality, and earnings persistence is an important aspect of it for investors. Therefore, agency theory is one of the important principles in explaining the effects of conservatism on earnings persistence (Nguyen, et al. 2025).

Previous research

Research on the effect of conservatism on earnings persistence has shown different results. Of course, these studies have been conducted in different environments and have used different models to estimate conservatism. An example of this research is discussed below. Chen et al. (2014), examined the effect of conditional and unconditional conservatism on earnings persistence and market reaction for a sample of American companies. Their

evidence showed that the use of conditional conservatism leads to less earnings persistence than the use of unconditional conservatism and the market reaction to conditional conservative earnings is less than to unconditional conservative earnings. Nguyen et al. (2025), examined the effect of accounting conservatism on earnings persistence of companies listed on the Vietnam Stock Exchange. Their findings showed that companies with more conservative reporting have more sustainable earnings. Penman et al. (1999), examined the effect of accounting conservatism on earnings quality and stock returns. Their results showed that when conservative accounting is accompanied by investment growth, it leads to a decrease in earnings and accounting rate of return through the creation of hidden reserves, and when conservatism is accompanied by a slowdown in investment, it leads to an increase in earnings and rate of return through the release of hidden reserves. If this increase or decrease in investment and its effects on earnings and rate of return are temporary, it leads to a decrease in earnings persistence. Watts et al. (2012), examined the effects of conditional and unconditional conservatism on earnings quality and stock prices for Egyptian companies. Their evidence showed that the use of conditional conservatism leads to a decrease in earnings quality and stock prices, but unconditional conservatism has no effect on earnings quality and has a negative effect on stock prices. Romadhoni et al. (2023), examined the effects of conservatism and multiple large shareholder structures on earnings quality in Indonesia. Their findings indicated that there was no relationship between conservatism and multiple large shareholder structures with earnings quality. Michael (1998), examined how accounting conservatism, firm growth, and earnings persistence affect firm value estimated based on earnings. His evidence showed that accounting conservatism, firm growth, and earnings persistence lead to an underestimation of firm value. Abdeldayem (2021), examined the relationship between conservatism and earnings quality and its implications for stock pricing. His test results showed that accounting conservatism leads to mispricing of long-term asset growth, and this mispricing leads to reduced earnings persistence. Afsheena et al. (2020), examined the effect of conservatism on earnings persistence in the Indian market. Their findings showed that conservatism has a negative effect on earnings persistence. Bryan et al. (2021), examined the relationship between conservatism and earnings management based on the provision for doubtful debts, and the test results showed that managers use excessive conservatism in the provision for doubtful debts to achieve earnings management goals. Islamiati (2023), examined the effects of investment opportunity set, accounting conservatism, and discretionary disclosure on earnings quality. The results showed that these variables have a negative impact on earnings quality. Hsieh et al. (2015), examined the relationship between accrual persistence and accounting conservatism. The evidence obtained showed that companies that are less conservative have more sustainable earnings. Mir et al. (2021), examined the effects of conservatism and product market competition on the sustainability of earnings and earnings components in the Iranian market. The research findings showed that conservatism and product market competition have a negative and significant effect on the sustainability and ability of earnings and its cash and accrual components to

predict future earnings. Yadegari et al. (2019), examined the effect of accounting conservatism on the sustainability of accruals in the Tehran Stock Exchange. The results of the study indicated that high degrees of accounting conservatism have a positive and significant effect on increasing the sustainability of accruals and correcting accrual abnormalities. Didar et al. (2016), examined the effect of conditional and unconditional conservatism on the quality of financial reporting. They used the criteria of accrual quality, earnings persistence, and disclosure quality for financial reporting quality. The results of the hypothesis test showed that conditional conservatism increases the quality of accruals and earnings persistence, but does not have a significant effect on the quality of disclosure, and unconditional conservatism does not have a significant effect on the quality of accruals and disclosure quality, but increases earnings persistence.

Research questions and hypotheses

In order to provide more empirical evidence on the consequences of applying conservatism as a controversial accounting principle, the following question is raised in this study:

- Does the degree of accounting conservatism have a reducing effect on the earnings persistence in companies listed on the Tehran Stock Exchange?

To answer the above question, the following two hypotheses are raised:

- 1- The level of conditional accounting conservatism has a negative and significant effect on the earnings persistence in companies listed on the Tehran Stock Exchange.
- 2- The level of unconditional accounting conservatism has a negative and significant effect on the earnings persistence in companies listed on the Tehran Stock Exchange.

Methodology

Population, statistical sample and research period

The statistical population of the study is all companies listed on the Tehran Stock Exchange, except for companies in the financial sector. The sample includes those companies in the population that have the following characteristics:

- 1- They have not changed their fiscal year during the period under review.
- 2- They are active on the stock exchange during the research period.
- 3- The company's fiscal year ends on March 20th. Because March 20th is the end of the fiscal year of most Iranian companies.

Considering the above conditions, the sample companies included 135 companies. Data from 2007 to 2016 were used to conduct the study.

Research model and research variables

In this study, the Ball and Shivakumar model was used to calculate conditional conservatism as follows:

$$ACC_t = b_0 + b_1 DCF_{Ot} + b_2 CFO_t + b_3 DCF_{Ot} * CFO_t + V_t(1)$$

In this model, ACC represents accruals, which are calculated based on the difference between net income and operating cash flow plus depreciation expense, CFO is operating cash flow, and DCF_O is a dummy variable that is equal to one if operating cash flow is negative and zero otherwise. Operating cash flows and accruals are standardized by assets at the beginning of the period. Given that losses are more likely to occur in periods with negative cash flows, the coefficient b₃ is expected to be positive for conservatism, and the higher it is, the greater the degree of

conservatism (Doustian, 2019).

In this study, non-operating accruals are used to measure unconditional conservatism. For this reason, accruals and non-operating items are used, since on the one hand, accrual accounting is a conduit for applying conservatism, and on the other hand, the exercise of discretion by managers in conditions of uncertainty provides the basis for applying conservatism. The use of this criterion is based on the assumption that the level of uncertainty in relation to items that are not part of the company's regular and continuous operations (non-operating items) is higher than the level of uncertainty in relation to items that are considered part of the company's normal activities. The sum of accruals, operating accruals (working capital) and non-operating accruals is calculated based on the Givoly and Hayn (2000) model as follows (Doustian, 2019; Mashayekhi, et.al 2009):

$$ACC=NI+DEP-CFO \quad (2)$$

$$WC=(\Delta CA - \Delta CF) - (\Delta CD - \Delta AP) \quad (3)$$

$$NOACC= ACC - WC \quad (4)$$

In these models, the variables are defined as follows:

ACC: Total Accruals, NI: Net Income, DEP: Depreciation Expense, CFO: Operating Cash Flow, WC: Operating Accruals, CA: Current Assets, CF: Cash, CD: Current Debt, AP: Short-Term Financing, NOACC: Non-Operating Accruals

Since smaller (negative) values of non-operating accruals indicate higher levels of conservatism, in this study, the negative of these items has been used to align the direction of the algebraic values of non-operating accruals with the level of conservatism (Mashayekhi, et.al 2009).

To test the first and second hypotheses of the study, the model introduced by Mashayekhi et al. (2009) is used as follows:

$$E_{it+1}=\alpha_0+\alpha_1.E_{it}+\alpha_2.DCON_{it}.E_{it}+\epsilon_{it+1} \quad (5)$$

Where:

E is net income divided by the market value of net assets.

DCON is a dummy variable that is 1 if the conditional or unconditional conservatism level of a company in a year is greater than the median of the conservatism level of all companies in that year, and otherwise its value is considered zero.

α_1 shows the earnings persistence of companies with low conservatism and $\alpha_1+\alpha_2$ shows the earnings persistence of companies with high conservatism. It is predicted that earnings persistence will decrease with increasing conservatism, or in other words, it is expected that $\alpha_2<0$ (as a result, $\alpha_1>\alpha_1+\alpha_2$ will be).

The model is estimated using panel data. To identify the type of regression model, the F-limer test and the Hausman test were used. The White test was used to examine the heterogeneity of variance. The data were analyzed using Eviews software.

Results

Descriptive statistics

Descriptive statistics related to the research variables are presented in Table (1).

Table 1: Descriptive statistics

	E	Y	CONS1	NOACC
Mean	0.112707	0.084012	-12.3954	126358.1
Median	0.125969	0.096004	0.000000	29418.4
				1545712
Maximum	0.389505	0.278229	107.1999	9

	-	-	-	-
Minimum	0.801818	0.557610	-1696.61	-8498953
Std. Dev.	0.137755	0.099080	145.75	1480587
Coefficient of variation	1.22	1.18	-11.76	11.72

In the present study, the Ball and Shivakumar model has been used to measure conditional conservatism, which is shown in the table as CONS1. As the results of the table show, the median of this variable is zero, which means that half of the observations have positive conditional conservatism and half of the observations have negative conditional conservatism. Therefore, the data used for conditional conservatism in this study have been divided into two equal portfolios. The coefficient of variation of both conservatism measures is high, which indicates that the variability of conservatism among the sample companies is high and that companies act differently in terms of conservatism.

Table 2: correlation between research variables

	E	Y	DCON1E	DCON2E
E	1.000000			
Y	0.643147***	1.000000		
DCON1E	0.007992	0.006214	1.000000	
DCON2E	0.697841***	0.50974**	0.041634	1.000000

*** Correlation is significant at the 1% level

Table (2) shows the correlation between the research variables. As can be seen, there is a positive and significant correlation of 64 percent between the current year's earnings variable (E) and the next year's earnings variable (Y). This shows that the prediction of future earnings is largely dependent on the current year's earnings figures. The variable DCON2E (related to the product of unconditional conservatism and earnings) has a positive and significant correlation with both the current year's earnings and the next year's earnings. The correlation between the variables related to conditional and unconditional conservatism is positive but not significant.

Model estimation and hypothesis testing

Table (3) shows the results of the model test of hypothesis 1. The F-limer test was used to determine the type of model in terms of pooled or panel. Since the test statistic had a significance level of less than 5 percent, the null hypothesis was rejected, and therefore the model under study was placed in the panel category. Then, the Hausman test was used to examine the fixed effects model versus the random effects model. The significance level of the test statistic was less than 5 percent, so the null hypothesis was rejected, and the fixed effects model was accepted.

Table 3: Results of the first hypothesis test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.031450	0.007841	4.010905	0.0001
E	0.467068	0.050484	9.251704	0.0000
DCON1E	-0.028281	0.217967	-0.129751	0.8968
R-squared	0.449498			
Adjusted R-squared	0.443657			
F-statistic	76.95731			
Prob(F-statistic)	0.000000			

The first hypothesis of the study predicted that applying conditional conservatism would lead to a decrease in earnings persistence. The results of testing this hypothesis, which estimates the coefficients of equation (5), are presented in Table (3). According to the first hypothesis, it was predicted that the coefficient α_2 in equation (5) would be smaller than zero and statistically significant. The results of Table (3) show that since the F statistic is significant, the model has the necessary significance. Also, the adjusted coefficient of determination of the model shows that 44 percent of the changes in the dependent variable (next year's earnings) can be explained by the independent variables of the model. The coefficient of the independent variable of current year's earnings is positive and statistically significant, and its value is 0.46, which indicates that the earnings of the sample companies have a medium level of stability. The coefficient α_2 , which is related to the variable DCON1E, is negative but not statistically significant, so the first hypothesis of the study cannot be accepted according to the evidence.

Table (4) shows the results of the second hypothesis test. The Limier F test was used to determine the type of model in terms of pooled or panel. Since the test statistic had a significance level of less than 5 percent, the null hypothesis was rejected, and therefore the model under study was placed in the panel category. Then, the Hausman test was used to examine the fixed effects model versus the random effects model. The significance level of the test statistic was less than 5 percent, so the null hypothesis was rejected, and the fixed effects model was accepted.

Table 4: Results of the second hypothesis test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.035738	0.007848	4.553683	0.0000
E	0.405695	0.058044	6.989495	0.0000
DCON2E	0.050491	0.056416	0.895006	0.3713

R-squared	0.401950
Adjusted R-squared	0.395688
F-statistic	64.18574
Prob(F-statistic)	0.000000

The second hypothesis of the study predicted that applying unconditional conservatism would lead to a decrease in earnings persistence. The results of testing this hypothesis, which estimates the coefficients of equation (5), are presented in Table (4). According to the second hypothesis, it was predicted that the coefficient α_2 in equation (5) would be smaller than zero and statistically significant. The results of Table (4) show that since the F statistic is significant, the model has the necessary significance. Also, the adjusted coefficient of determination of the model shows that 39.5 percent of the changes in the dependent variable (next year's earnings) can be explained by the independent variables of the model. The coefficient of the independent variable of current year's earnings is positive and statistically significant, and its value is 0.4, which indicates that the earnings of the sample companies have a medium level of stability. The coefficient α_2 , which is related to the variable DCON2E, is positive and not statistically significant, so the second hypothesis of the study cannot be accepted according to the evidence.

Summary and Conclusion

Following Basu (1997), conservatism is often interpreted as recognizing a decline in earnings more quickly than an increase in earnings or using higher degrees of reliability to recognize an increase in earnings than a decline in earnings. Recognizing earnings-reducing events more quickly and more timely than non-recognizing earnings-increasing events can lead to recognizing part of the costs of future periods in the current period. This, in turn, can reduce earnings persistence and impose the cost of making wrong decisions on actual and potential investors (Mashayekhi, et.al 2009). In this study, conservatism was calculated using two measures of conditional conservatism (Ball and Shivakumar model) and unconditional conservatism (negative of non-operating accruals). Then, the prediction that conservatism leads to a decrease in earnings persistence was tested. The results showed that none of the conservatism measures had an effect on earnings persistence, which is in line with the results of Mashayekhi et al. (2009) research in this field. Of course, Mashayekhi et al. (2009) also used an alternative test and conducted the test using an alternative measure of non-operating accruals, i.e. the ratio of adjusted net asset value to book value, and the results showed that conservatism has a negative effect on earnings persistence. Therefore, the results will be different depending on which measure of conservatism is used. Also, the results of the test of both models showed that companies listed on the Tehran Stock Exchange have relatively average earnings persistence.

Suggestions

Considering the results obtained from this study, it is suggested that in order for the research results to be more reliable, other conservatism criteria used in reputable research should be used to conduct the research and the

results should be compared.

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