Conditional Conservatism and Reactions of Equity Investors on Management Earnings Forecasts of Firms in Thailand

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ABSTRACT

Manuscript type: Research paper

Research aims: This research tests the contracting efficiency of conservatism by investigating the relationship between conditional conservatism and the reactions of equity investors on management earnings forecast disclosures.

Design / Methodology / Approach: The tests were conducted on firms listed in Thailand. Conditional conservatism was measured by using Khan and Watts' (2009) model. The cumulative market-adjusted abnormal returns approach was used to measure market reactions to management earnings forecast disclosures.

Research findings: Findings show that conditional conservatism is positively associated with cumulative excess returns around earnings forecasts release dates. This suggests that conditional conservatism mitigates information asymmetry by committing managers into disclosing credible earnings forecast information. This leads to positive reactions by equity investors.

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Theoretical contributions / Originality: This paper fulfills an identified need in studying how conservatism enhances the value of voluntary disclosure information and how it influences market reactions to management earnings forecast disclosures.

Practitioner/Policy implications: This paper includes implications for the development of disclosure rules for Thai firms and for the improvement of the prudence approach in the conceptual accounting framework.

Keywords: Conditional Conservatism, Management Earnings Forecast Disclosure, Shareholder Value, Stock Market Reaction

JEL Classification: G14, G17, M41

1. Introduction

Accounting conservatism is considered to be a key qualitative characteristic of financial reporting. It embraces the application of a higher verifiability standard which recognises good news as gains rather than bad news as losses (Watts, 2003; LaFond & Watts, 2008; Ball, Robin, & Sadka, 2008; IASB, 2015). Conservatism can be categorised as conditional conservatism and unconditional conservatism (Mora & Walker, 2015). To begin with, unconditional conservatism refers to accounting practices that reduce earnings and net assets in an unavoidable manner (Watts, 2003; Hellman, 2008; Bandyopadhyay, Chen, Huang, & Jha, 2010). In contrast, conditional conservatism is defined by Watts (2006, p.52) as "a higher standard of verifiability for the recognition of gains than for losses". In conditional conservatism, earnings and net assets are reduced when negative news arise. However, increases in these two figures do not necessarily occur when there is positive news (Basu, 2005; Ryan, 2006). Conditional conservatism, therefore, ensures that reported earnings will incorporate the expected losses in a timely manner, while proposing the recognition of expected gains only when they are verified. The disclosure of economic losses in a timely manner helps to reduce agency costs which may arise due to information asymmetry between managers and investors (LaFond & Watts, 2008). It is this feature that makes conditional conservatism a reflection of quality in financial reports and provides an early warning of a decline in performance (Ball, 2001; Ball et al., 2008; Kothari, Ramanna, & Skinner, 2010; Mora & Walker, 2015). This economic event can potentially increase the value relevance of earnings number (Bandyopadhyay et al., 2010; Kim & Kross, 2005). Thus, the focus of

this paper is on investigating the role of conditional conservatism in capital markets.

The topic on "conservatism" or "prudence" is interesting in the accounting literature following the removal of the terms from the Conceptual Framework for the Financial Statement of 2010 and its subsequent re-instatement into the Exposure Draft Conceptual Framework of 2015. The Exposure Draft Conceptual Framework 2015 states that conservatism or prudence is important for achieving neutrality. It is an aspect that makes financial statements useful to investors (IASB, 2015). Conservatism and financial statement verifiability are important characteristics of the generally accepted accounting principles (GAAP) (Kothari et al., 2010; Francis, Hasan, & Wu, 2013). Prior literature suggests that shareholders have greater preference for conservative accounting practices as they reduce litigation risks and mitigate agency problems (Guay & Verrecchia, 2007; LaFond & Watts, 2008; Ball, Jayaraman, & Shivakumar, 2012). Furthermore, conservative reports are found to influence managers' decisions in issuing earnings forecasts (Hui, Matsunaga, & Morse, 2009; Li, 2007). Such evidence are consistent with the suggestion that mandatory financial reports are used to confirm the credibility of voluntarily disclosed information (Ball, 2001). In addition, conditional conservatism serves as a measure of quality for mandatory financial reports. It also plays a complementary role in voluntary management forecast disclosures (Hui et al., 2009). However, the topic on how conditional conservatism influences the reactions of equity investors towards earnings forecasts made by managers has not been empirically investigated.

This study, therefore, investigates firm-level's relationship between conditional conservatism and the reactions of equity investors on management earnings forecast disclosures. An explanation on how conditional conservatism can influence stock returns around management earnings forecast disclosure period is explained based on three possible concepts. First, conditional conservatism alleviates agency costs which have been incurred through asymmetric information (Watts, 2003; Ball & Shivakumar, 2005; LaFond & Watts, 2008) and it provides investors with verified accounting information for monitoring corporate investment decisions and for assessing the firm's future cash flows. Secondly, conservative reports help to establish a better benchmark depicting the firm's current and future financial performances besides providing a more verifiable and lower bound measure for earnings and net asset values (Watts & Zuo, 2011; Kim, Li, Pan, & Zuo, 2013). When combined

with management forecasts of strategically disclosed economic events, conservative reports offer investors verified accounting information that contains the firm's true economic value. Thirdly, based on Ball's (2001) confirmatory hypothesis, audited financial reports provide investors with verified accounting information that can be used as a baseline for evaluating the credibility of unverified voluntary information derived from alternative public sources (Ball, 2001; Watts, 2006; Ball et al., 2012) including management earnings forecasts. Firms that apply greater conditional conservatism commit managers to disclosing information regarding negative economic events in a timely manner (Watts, 2006; Guay & Verrecchia, 2007). This requirement necessitates managers into showing more integrity when disclosing earnings forecasts, thereby, leading to a full information disclosure that relates to the firm's value. This factor is likely to create more intense stock market reactions towards management earnings forecasts since the forecasts are more credible and relevant. Therefore, conditional conservatism is expected to be positively associated with cumulative excess returns around the period when earnings forecasts are announced by managers.

To test the research hypothesis, conditional conservatism is measured by using Khan and Watts' (2009) firm-year measures of conditional conservatism (*C_SCORE*). Using a sample of 923 firm-years of firms listed on the Stock Exchange of Thailand (SET) which had issued annual management earnings forecasts over the period of 2005-2012, this study finds that the cumulative excess (abnormal) returns surrounding the issued management earnings forecast dates are significantly and positively associated with conditional conservatism. The results suggest that the influence of conditional conservatism on stock returns around the period of earnings forecasts disclosure can be explained by the alleviation of agency costs caused by information asymmetry and the confirmation of management forecast information accuracy. The finding is consistent with the reports made by LaFond and Watts (2008) and Ball et al. (2012). The results are sufficiently reliable when using the scaled decile rank of the *C_SCORE* to capture conditional conservatism, and the non-operating accrual approach recommended by Givoly and Hayn (2000) to capture both conditional and unconditional conservatism.

This study expands on the literature pertaining to the economic implications of conditional conservatism, particularly its implications on the capital markets. With conservatism identified as an important characteristic of financial reports, a number of empirical studies have aimed to test its effects in debt markets (Kothari, 2001; Beatty, Weber,

& Yu, 2008; Ball et al., 2008). The findings of this study support the concept that conditional conservatism increases the ability of current earnings in predicting future operations, supporting Bandyopadhyay et al. (2010). In this regard, conditional conservatism thus, adds value to voluntary disclosure information in conveying and correcting investors' earnings expectations.

This study also contributes to management forecast literature by connecting the effects of management earnings forecast disclosure to the degree of conservatism in the accounting system. The findings suggest that verified financial information derived from conservatism accounting influences the reactions of equity investors on forecasting information. This is achieved by reducing the degree of information asymmetry in the markets and limiting the management's legal exposure from withholding bad news, a finding that is consistent with Ball's (2001) confirmatory hypothesis.

In addition, the findings provide the practical implications of mandatory conservative report and voluntary management forecast disclosure for regulators and accounting standard setters in Thailand. After the 1997 Asian financial crisis, corporate governance reforms in Thailand had a positive impact on conservatism accounting practices and the timeliness of earnings (Vichitsarawong, Eng, & Meek, 2010). Meanwhile, Thai policy-makers and the Securities and Exchange Commission (SEC) had issued a guideline of disclosure in 2005 to improve corporate information environment and transparency. Thailand is an emerging market with an institutional environment that consists of complicated ownership structures, weak corporate governance and information in a market which has been described as less efficient when compared to developed markets (Wiwattanakantang, 2001; Connelly, Limpaphayom, & Nagarajan, 2012). Since conservative accounting practices can enhance the relevance of earnings figures, this study may provide more direct value for policy-makers in Thailand's institutional environment. Thus, it is essential for academic scholars and regulators to gain knowledge in understanding the role of reported financial information and voluntary disclosure information particularly for countries with emerging markets.

Finally, the findings of this study contribute to the issue of reintroducing the long-debated concept of prudence characteristics (also termed "conservatism") in financial statements as stated in the Exposure Draft Conceptual Framework 2015 (IASB, 2015). Findings from this study support the value relevance of accounting information

that is generated from conservative accounting (Mora & Walker, 2015). In addition to several studies in the contracting efficiency approach that have shown preference for conservatism (Kothari et al., 2010; Francis et al., 2013; Barker & McGeachin, 2015; Andre, Filip, & Paugam, 2015), this study provides additional supporting evidence for policy-makers to consider and to evaluate the pros and cons of accounting conservatism when developing conceptual framework and accounting standards.

The remainder of this paper is organised as follows: section 2 presents the discussion of previous literature and develops the hypotheses; section 3 presents the data, variable definitions and model specifications; section 4 presents the empirical results; section 5 presents an additional test; and finally, section 6 concludes the paper.

2.   Literature Review and Hypothesis Development

2.1   *Accounting Conservatism under IFRS and Empirical Studies in Thailand*

The International Financial Reporting Standards (IFRS), mandatorily adopted by many countries including Thailand, went through a number of significant changes. First of all, the terms "conservatism" and "prudence" were eliminated from the 2010 Conceptual Framework for Financial Reporting (IASB, 2010). The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) claimed that conservatism was in conflict with neutrality and could cause bias in the understatement of net assets incorporated in financial statements (IASB, 2010; IASB, 2015). Thus, the term was removed.

Academic scholars have suggested that the elimination of conservatism has changed managerial behaviours and imposed significant costs on investors and the economy in general (Kothari et al., 2010; Francis et al., 2013; Barker & McGeachin, 2015; Andre et al., 2015; Mora & Walker, 2015). In addition, Kothari et al. (2010) and Francis et al. (2013) suggest that conservatism and financial statement verifiability are two important characteristics to consider for the generally accepted accounting principles (GAAP) as both have been shaped by equity market forces. Several mechanisms which guaranteed the use of conditional conservatism including, lower costs or net realisable values for inventories, recognition of probable liabilities versus the non-recognition of contingent assets, or the impairment for financial assets and long-lived assets (Barker & McGeachin, 2015; Mora

& Walker, 2015) are explicitly included in accounting standards. This has led to the embedment of the concept of conservatism or prudence into accounting standards (Andre et al., 2015; Barker & McGeachin, 2015). In the recently revised Exposure Draft Conceptual Framework 2015, the IASB proposed to reintroduce the concept of prudence as an approach of increasing the usefulness of financial statements for investors (IASB, 2015). This implies that there is a need to give focus to conservatism.

Existing research provides evidence that a firm's accounting policy is affected by the specific institutional settings. This has led to the degree of conservatism in each firm, industry and country to vary (Ball et al., 2008; Mora & Walker, 2015). Ball, Robin, and Wu (2003) examined the conservative reporting practices of four East Asian countries (Hong Kong, Malaysia, Singapore and Thailand) during the period of 1984-1996. They find that the earnings reports made by Thai listed firms do not reflect any conservative accounting method choices. In extending the works of Ball et al. (2003), the study by Vichitsarawong et al. (2010) reveals that during the financial crisis which hit the region in 1997, aspects of timeliness and conservatism were found to be low. During the post-crisis period, however, conservatism was noted to have increased at a level even higher than the period before the crisis. Based on these observations, it can be inferred that reforms in corporate governance play an important role in increasing the level of transparency in corporate financial reports in Thailand as observed by the improved conservatism in the post-crisis period. Boonlert-U-Thai and Kuntisook (2009) examined the effects of controlling shareholders' characteristics on the financial reporting conservatism of Thai listed companies during 2000-2006. They find that conservatism, as measured by asymmetric timeliness of earnings, had increased with greater controlling shareholder ownership in founding family firms. Overall, prior studies had identified that debt contracting, compensation contracting and corporate governance structure are the drivers of conservatism in financial statements of Thai listed firms.

2.2   Hypothesis Development

This study aims to investigate the effects of conditional conservatism on stock market reactions to management earnings forecast disclosures. Conditional conservatism potentially affects stock returns in several ways during the period when management forecasts are released. First, conservative accounting constrains the management's asymmetric disclosure incentives. This contracting efficiency approach is explained by the nature of conditional conservatism that will offset managerial

actions in concealing bad news events and accelerating good news events into public information sources (LaFond & Watts, 2008). Consequently, the bad news will be conveyed to the market in a timelier manner than the announcements of unverified good news. This mechanism will help to alleviate agency costs which are associated with information asymmetry. In addition, it will equip investors with better tools for monitoring corporate managers and in limiting managers' ability to misrepresent earnings information (Watts, 2003; Ball & Shivakumar, 2005). These factors will enable investors to better evaluate the company's level of voluntary disclosure transparency when earnings forecasts are released.

Secondly, because conditional conservatism forces the earlier recognition of economic losses in earnings and net assets, the net asset value of a more conservative-reported firm is thus, more likely to be closer to its fundamental value than that of a less conservative firm (Watts & Zuo, 2011; Kim et al., 2013; Francis et al., 2013). For instance, firms that have been more conservative are found to be facing less negative market reactions towards seasoned equity offering announcements as compared to their less conservative counterparts (Kim et al., 2013). In addition, Bandyopadhyay et al. (2010) show that conditional conservatism increases the predictive ability of current earnings for future operating cash flows. Based on this value relevance viewpoint, it is thus deduced that when management earnings forecasts are disclosed and when bad news are released, the negative reaction of stock prices to earnings forecast information would be weaker among the more conservative-reported firms than for firms with less conservatism. In this regard, investors could use the conservative financial reports and voluntary earnings forecast information as a means to price their firms more accurately during the time when forecasts are released.

Thirdly, conservative financial reports tend to provide more verified and confirmatory voluntary financial information as suggested by Ball's (2001) confirmatory hypothesis. According to the confirmatory viewpoint, an information environment which consists of publicly accessible and verified accounting information tends to require the firms to be more honest with their voluntary disclosures. This can consequently, provide a more accurate information to the relevant parties. Thus, reports focusing on ex-post audited financial outcomes would allow investors to make better decisions because they are able to compare the different sources of voluntary disclosures with the realised numbers present in audited financial statements (Ball et al., 2012; Watts, 2006). In this respect, information generated from those conservative

reports could serve as a better benchmark for evaluating unverified information which were acquired from various other sources, including the earnings forecasts made by managers (Ball et al., 2012; Watts, 2006). If firms that apply conservatism in their reports issue earnings forecasts that are perceived by the market as being highly accurate in predicting future cash flows, then investors are more likely to reward them by engaging in approaches that give less emphasis on price protection. This practice may therefore, mitigate stock price reduction when firms disclose their private information (Guay & Verrecchia, 2007).

Taken together, the effects of conditional conservatism in reducing agency costs and facilitating governance will increase investors' perceptions about the company's credibility and transparency in their earnings forecast disclosures. In this regard, firms with a greater degree of conservative reports will have larger excess returns at the time when earnings forecasts are disclosed as compared to firms with lower conservatism (excess returns is a measurement of reactions of investors on management forecast disclosures). It is thus, hypothesised as follows:

> There is a positive relationship between conditional conservatism and cumulative excess returns around management earnings forecast dates.

3. Sample and Measurement of Variables

3.1 Sample and Data

The sample in this study comprises the firms listed on the Stock Exchange of Thailand (SET) that issued their annual management earnings forecasts during the period of 2005-2012. The firms in the financial and banking industry are excluded from this study because financial institutions are under strict bank regulations, requirements, restrictions and guidelines[1] which are governed by the Bank of Thailand (BOT) and the Ministry of Finance. In Thailand, firms release their earnings forecast information through press releases and newspapers. Therefore, the management earnings forecasts for each fiscal year were manually collected from the NEWSCENTER database while accounting and financial data were obtained from the DATASTREAM database.

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[1] The bank regulation (Chapter 3 Supervision of Financial Institutions) comprises of 10 divisions: maintenance of capital funds and assets, investment of financial institutions, business undertaking, etc. (BOT, 2008).

In the sample selection process, only the firms' earnings, which are point and range forecasts were included in the study because in comparison to other types of forecasts, quantitative earnings forecast information are the most well-defined (Gong, Li, & Xie, 2009). The earnings forecast must be based on the firm's news (Jarutakanont & Supattarakul, 2013). In addition, the earnings forecast data were limited to the initial earnings forecasts rather than the updated annual forecast or pre-announce earnings. This is because an initial forecast captures the managerial expectations and their true beliefs concerning the firm's future prospects (Gong et al., 2009). Finally, the earnings forecasts of each firm must be found in at least two different data sources. This criterion confirms that the data retrieved from the management earnings forecasts are valid and can be used in the analysis.

To control the confounding effects derived from other events (following Jarutakanont and Supattarakul's (2013) approach), this study excluded management forecasts of firms which had other events during the seven days (-3 to +3) surrounding the management forecast release date. These other events include: (1) earnings announcements; (2) dividend announcements; (3) new stock issuances announcements; and (4) share repurchase announcements. News considered as other events were identified from firm/securities information noted in the SET website, SEC website and the SETSMART database.

Based on the criteria above, a final sample of 923 firm-years[2] (227 distinct firms) were included in this study. The selection process of the sample is as follows:

Annual management earnings forecasts for fiscal years 2005-2012	1,267
Less: Management earnings forecasts that are disclosed prior to the year *t* earnings announcement date or after the year *t*+1 earnings announcement date	(178)
Management earnings forecasts that have other events around disclosure date	(146)
Disclosure firms without complete financial data sets (during 2000-2012)	(20)
Final annual management earnings forecasts for fiscal years 2005-2012	923

[2] The sample of 923 firm-years comprise of agro and food (74 firm-years), consumer products (40 firm-years), industrials (125 firm-years), property and construction (267 firm-years), resources (115 firm-years), services (188 firm-years) and technology industries (114 firm-years).

3.2 Measure of Accounting Conservatism

To test the research hypothesis, the firm-specific conservatism (*C_SCORE*) which is similar to that of Khan and Watts' (2009) was used as the primary measure for determining conditional conservatism. Based on Basu's (1997) asymmetric earnings timeliness measure which captures conditional conservatism, Khan and Watts developed a firm-year measure of conservatism which is the *C_SCORE*, with the purpose of examining events that involve a change in conservatism. They were able to show that conservatism would increase in response to an increase in the asymmetric information, idiosyncratic uncertainty and the likelihood of litigation. Thus, Khan and Watts (2009) modified Basu's (1997) conservatism model by incorporating the firm-specific characteristics, i.e., firm size, market-to-book, and leverage ratio into their own study. It is the model developed by Khan and Watts that was used in the current study.

The decision to use firm-specific conservatism is based on three reasons. First, the firm-specific measure model (Khan & Watts, 2009) was developed from Basu's (1997) asymmetric timeliness of earnings. Here, the operationalised definition of conservatism is the use of a higher verification threshold to recognise good news about expected future cash flows as gains rather than the recognition of bad news as losses (Basu, 1997; Watts, 2003). Secondly, Khan and Watts' (2009) approach is consistent with Ball, Kothari, and Nikolaev (2013) who find that estimates of asymmetric timeliness tend to vary across firms due to the diversity in size, market-to-book ratio, and leverage. These three characteristics are argued to influence the expected earnings and returns, thereby, making them basic factors to be used when empirically studying systematic variations of bias. According to Ball et al. (2013), systematic variations in bias are removed when certain factors related to corporate earnings are controlled for. In this case, the characteristics mentioned above are normally set as proxies when studying conditional conservatism (Khan & Watts, 2009). Thirdly, the nature of this study requires a firm-year level conservatism measure of the year prior to the management forecast disclosure date. This has been verified by Khan and Watts' (2009) *C_SCORE* which assumes a linear function of firm-specific characteristics each year. Thus, Khan and Watts' (2009) *C_SCORE* can be used in multiple regression models to attain statistical significance.

To calculate the conditional conservatism level, this study estimates Equation (1), the cross-sectional model, for each year of the sample period using all observations with the necessary financial data:

$$\frac{X_i}{P_{t-1}} = \beta_0 + \beta_1 DR_i + RET_i \,(\mu_1 + \mu_2 SIZE_i + \mu_3 MB_i + \mu_4 LEV_i) \qquad (1)$$
$$+ DR_i RET_i \,(\lambda_1 + \lambda_2 SIZE_i + \lambda_3 MB_i + \lambda_4 LEV_i)$$
$$+ (\delta_1 SIZE_i + \delta_2 MB_i + \delta_3 LEV_i + \delta_4 DR_i SIZE_i + \delta_5 DR_i MB_i + \delta_6 DR_i LEV_i) + \varepsilon_i$$

Where X_i is the earnings per share reported by firm i, P_{t-1} is price per share at the beginning of year of firm i; RET_i is a proxy for the news concerning each firm's performance, which is calculated from the cumulative buy-and-hold stock returns of firm i over 12 months, beginning from the ten months prior to the end of the fiscal year; DR_i is the indicator variable that takes the value of "1" if returns (RET_i) are negative, and "0" if otherwise. $SIZE_i$ is the natural logarithm of market value of common equity; MB_i is the market-book ratio, defined as the market value of equity dividend by book value of equity; and LEV_i is the leverage ratio, calculated as the total liabilities divided by the market value of equity.

For each firm-year observation, the estimated coefficients λ_1, λ_2, λ_3, and λ_4 which are derived from Equation (1) are used to calculate the firm-year specific conservatism, C_SCORE, which is henceforth, calculated as Equation (2):

$$C\_SCORE_i = \lambda_1 + \lambda_2 SIZE_i + \lambda_3 MB_i + \lambda_4 LEV_i \qquad (2)$$

The degree of conservatism of firm i was obtained from the C_SCORE in Equation (2). Firms with a higher C_SCORE are considered to have a greater degree of conditional conservatism.

3.3 Stock Market Reaction

The stock market reaction is defined as the cumulative market-model abnormal returns around the management forecast disclosure date (MEFCAR). This study follows the standard event study approach using a market-adjusted model to capture the excess returns or abnormal returns (Brown & Warner, 1980). For a given event period, daily excess returns is calculated as the firm's equity returns minus the expected or estimated returns of the security in dates around the forecast disclosure. The market-adjusted returns approach assumes that expected returns are the same for all securities. In this approach, the daily excess returns of the listed firms in Thailand were measured as the buy-and-hold stock returns of the security less the daily market returns or change in

the SET index (SET index as benchmark returns). In the next step, the cumulative excess returns (*CARs*) were calculated by compounding the daily excess returns for a three-day window (day *t*-1 to day *t*+1) so as to capture market reactions around the management forecast release date (Anilowski, Feng, & Skinner, 2007).

3.4 Regression Model

The objective of this study is to investigate the effects of conditional conservatism on stock market reactions to management earnings forecast disclosures. This study tests the hypothesis by estimating the following regression model:

$$
\begin{aligned}
MEFCAR_{i,t+1} = \ & \beta_0 + \beta_1 C\_SCORE_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 DEBT_{i,t} + \\
& \beta_4 MB_{i,t} + \beta_5 EPS_{i,t} + \beta_6 BV_{i,t} + \beta_7 NEWS_{i,t} + \\
& \beta_j \Sigma_j IND_{i,t} + \varepsilon_{i,t}
\end{aligned} \tag{3}
$$

The dependent variable, *MEFCAR*, is a three-day accumulated adjusted excess returns around the management earnings forecast disclosure date (day *t*-1 to day *t*+1) (Anilowski et al., 2007). The variable of interest is the conditional conservatism measure which is the *C_SCORE*. In testing the hypothesis, the relationship between conditional conservatism and higher accumulated excess returns is expected, or the coefficient β_1 is expected to have a positive sign and to be statistically significant. All control variables are discussed in section 3.5.

3.5 Control Variables

The control variables include a set of firm characteristics and other factors which have been found to be associated with firms' returns. Khan and Watts' (2009) suggestion stating that empirical research which employ the *C_SCORE* can control firm size, debt ratio, and market-to-book ratio was followed. This is because failure to do so may lead to spurious correlations (García Lara, Osma, & Penalva, 2014). In this study, firm size (*SIZE*) is defined as the natural logarithm of the book value of total assets. Prior studies have suggested that stock returns are associated with firm size. Bamber (1987), for instance, finds that large firms have smaller abnormal trading volumes around the announcement date as compared to small firms do. Thus, it is expected that the excess returns is negatively associated with firm size. Debt ratio, *DEBT*, is

defined as the ratio of the book value of short-term debt and long-term debt over the book value of the total assets. Prior studies have provided evidence that stock returns are negatively related to debt ratio (Kim & Pevzner, 2010). Moreover, the market-to-book ratio (*MB*) is calculated as the market value of equity divided by the book value of equity in the year prior to management forecast disclosure. A positive relationship between stock market reactions and the firm's growth potential is expected (Kim et al., 2013).

Accounting literature have indicated that earnings information i.e., earnings per share, is associated with a firm's stock price (Collins, Maydew, & Weiss, 1997; Francis & Schipper, 1999). In this regard, earnings per share (*EPS*) is calculated as earnings before extraordinary items deflated by the number of outstanding common shares. It is predicted that firms with high earnings per share will have high cumulative excess returns around management disclosure dates. Further, it is noted that the book value of equity (*BV*) can be considered as another factor that helps to explain the change in stock returns (Kothari, 2001). The quality of financial reporting can affect both the book value of equity and the market value of equity. Thus, the book value of equity should be closely related to the market value of equity. The book value of equity, *BV*, is measured as total assets less total liabilities and then deflated by the number of outstanding common shares.

It has been noted from prior empirical studies that the reaction of the stock market towards good news forecasts tend to be different from that of bad news forecasts (Kim & Pevzner, 2010; Ball et al., 2012). The works of Jarutakanont and Supattarakul (2013) are referred to when classifying the news of management earnings forecast disclosure (*NEWS*). These disclosures are classified as either bad news forecasts or good news forecasts and this is noted based on the signs of the cumulative excess returns seven days around the disclosure date (day *t*-3 to day *t*+3). The same method is applied to the current study where management forecast disclosures with negative cumulative market-adjusted returns are classified as bad news and thus, are assigned the value "1". On the other hand, cumulative market-adjusted returns with a positive sign are considered to be good news and so are assigned the value "0".

Consistent with the findings of previous studies (Kim et al., 2013), a dummy variable reflecting industry codes (based on the specifications of the SET) was also added to account for its potential effects on variations in the stock returns of the firm. Listed firms included in the study were

categorised into seven industries comprising agro and food, consumer products, industrials, property and construction, resources, services, and technology industries. Based on the SET, the industry control variable (ΣIND) served as the indicator variable. The variable was assigned a "1" if firm *i* is in industry *j* in year *t,* and a "0" if it is not. All the above independent variables were measured in the year prior to the management forecast disclosure, except for *NEWS*, which was measured in accordance with the year that the management earnings forecast was disclosed. Details of the definitions for all control variables used in the empirical analyses are tabulated in Table 1.

Table 1: Control Variables

Variable	Definitions	Expected signs	Reference
SIZE	Firm size, measured as the natural logarithm of the market value of equity	+	Bamber (1987)
DEBT	Debt ratio, measured as ratio of the book value of short-term and long-term debt over the book value of total assets	-	Kim and Pevzner (2010)
MB	Market value of equity divided by book value of equity	+	Kim et al. (2013)
EPS	Earnings per share, calculated as earnings before extraordinary items deflated by number of outstanding common shares	+	Collins et al. (1997); Francis and Schipper (1999)
BV	Book value of equity, measured as the total assets less total liabilities, then deflated by number of outstanding common shares	+	Kothari (2001)
NEWS	News forecast, identified as bad news with value of "1" if the sign of cumulative excess returns is negative and good news with value of "0" if the sign of returns is positive	+/-	Kim and Pevzner (2010); Ball et al. (2012); Jarutakanont and Supattarakul (2013)

4.   Results

4.1   Accumulative Excess Returns

Table 2 reports the average excess returns (abnormal returns) and the accumulative excess returns from seven days prior to and seven days after the management forecast disclosure date (day *t*-7 to day *t*+7). As shown in the table, a significant stock returns change is visible around the disclosure date (day 0). The average daily excess returns on day -1, day 0 and day +1 are 0.800, 0.604 and 0.095 per cent, respectively. The cumulative abnormal returns in the three-day window (*MEFCAR*) is 1.670 per cent and a *t*-statistic of 5.589 (*p*<0.000), which is significantly greater than zero at the .01 level. The findings provide empirical evidence that there are significant market reactions surrounding the forecast disclosure dates, consistent with the findings of Jarutakanont and Supattarakul (2013). The results suggest that the management earnings forecasts of listed firms in Thailand are informative.

Table 2: Average Excess Return and Accumulative Excess Return around Management Earnings Forecast Disclosures

Day	Average Excess Return (%)	Accumulative Excess Return (%)
-7	0.114	0.114
-6	0.186	0.300
-5	0.135	0.435
-4	0.378	0.813
-3	0.261	1.074
-2	0.517	1.591
-1	0.800	2.391
0	0.604	2.995
+1	0.095	3.090
+2	0.147	3.237
+3	0.168	3.405
+4	0.223	3.628
+5	0.285	3.913
+6	0.406	4.319
+7	0.080	4.399
MEFCAR (-1, 0, +1)	1.670	
t-statistic	5.589	
Observations	923	

Table 2 reports the average excess returns and accumulated excess returns from seven days prior until seven days after the disclosure dates of the 923 management earnings forecasts in the samples over the period from 2000 to 2012.

Figure 1 presents the distribution of the average daily excess (or abnormal) returns from seven days prior and seven days after the management earnings forecast disclosure date (day 0). This figure shows a sharp increase in the average daily excess returns on the day prior to the management earnings forecast disclosure date (day t-1). In other words, the average excess returns of sample firms change from 0.517 per cent in day t-2 to 0.800 per cent in day t-1, and then these decline slightly to 0.604 per cent on the disclosure date. Figure 1 suggests that the reason behind the movement in returns is due to the market's anticipation of management earnings forecasts before the disclosure date. In other words, the stock prices reflect the earnings forecast news that are conveyed by the firms.
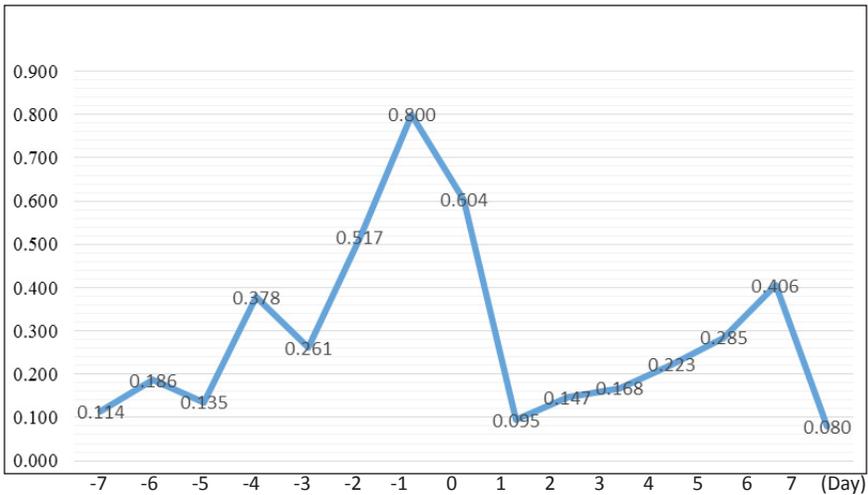

Figure 1: Average Daily Excess Returns Around the Management Earnings Forecast Disclosure Dates

Figure 2 presents the cumulative excess returns around the earnings forecast disclosures (*MEFCAR*) across the decile rank of *C_SCORE*. Figure 2 shows that the cumulative abnormal returns at the lowest decile

of the *C_SCORE* which appears to increase slightly from around -0.10 per cent to 0.15 per cent at the highest decile rank of the *C_SCORE*. Overall, the findings suggest that the cumulative abnormal returns around the earnings forecast disclosure date increases according to the degree of conditional conservatism.
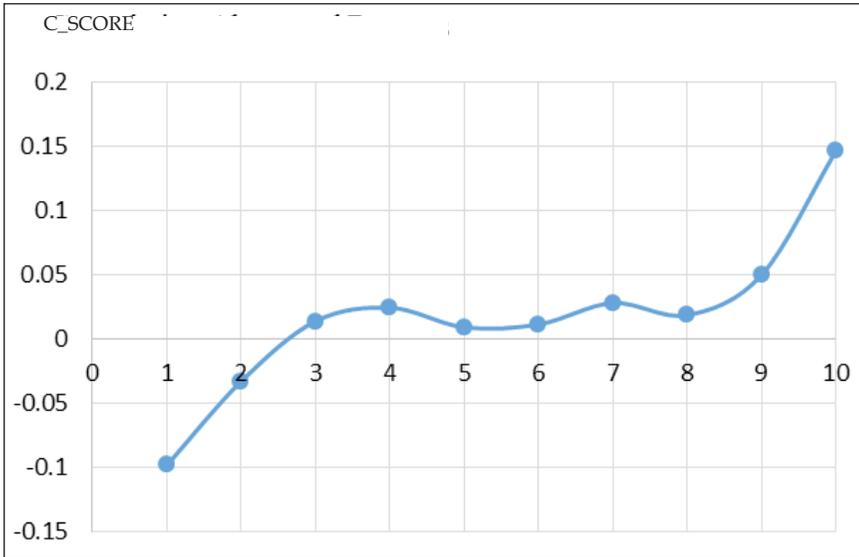

Figure 2: Cumulative Abnormal Returns Around Management Earnings Forecast Disclosure Dates Across Decile Rank of Conservatism

4.2   *Descriptive Statistics*

Panel A of Table 3 demonstrates the descriptive statistics of the independent and dependent variables that were used in regression analysis. Over the entire sample period, *MEFCAR* has the mean and medium value of 1.7 and 1.2 per cent, respectively. The mean and median values of the *C_SCORE* are 0.109 and 0.108, respectively.

The control variables also exhibit reasonable variations; the mean and median values of the firm size (*SIZE*) are 21.202 and 21.084, respectively. The mean and median values of the debt ratio (*DEBT*) are 0.478 and 0.491, respectively. The mean and median values of the market-to-book ratio at the beginning of the fiscal year (*MB*) are 2.365

and 1.454, respectively. The mean (median) values of earnings per share (*EPS*) and the book value of equity (*BV*) are 2.566 baht (0.740 baht) and 14.170 (4.970), respectively. About 45.7 per cent (422 firm-years) of the samples belong to firms with disclosed management earnings forecasts which are considered as bad news (*NEWS*).

Table 3: Summary Statistics

Panel A: Descriptive Statistics

Variable	Mean	Standard Deviation	Median	Minimum	Maximum
MEFCAR	0.017	0.091	0.012	-0.228	0.290
C_SCORE	0.109	0.056	0.108	0.011	0.275
SIZE	21.202	1.456	21.084	18.630	24.060
DEBT	0.478	0.184	0.491	0.018	0.997
MB	2.365	13.399	1.454	0.178	23.100
EPS	2.566	6.418	0.740	-12.580	91.000
BV	14.170	25.456	4.970	0.050	173.700
NEWS	0.457	0.498	0.000	0.000	1.000

Panel B: Correlation Matrix

Variable	MEFCAR	C_SCORE	SIZE	DEBT	MB	EPS	BV
C_SCORE	**0.662**						
SIZE	**-0.108**	**-0.071**					
DEBT	**-0.276**	**-0.207**	0.299				
MB	-0.043	-0.003	0.056	**0.101**			
EPS	**0.078**	0.058	**0.384**	-0.062	-0.007		
BV	0.032	0.041	**0.433**	**-0.101**	-0.019	**0.871**	
NEWS	**-0.749**	**-0.501**	0.053	**0.248**	0.047	**-0.071**	-0.042

Note: *MEFCAR* denotes a three-day accumulated adjusted excess (abnormal) returns around the management earnings forecast disclosure date; *C_SCORE* denotes conservatism, estimated following the approach of Khan and Watts (2009); *SIZE* denotes firm size, measured as the natural logarithm of the market value of equity; *DEBT* denotes debt ratio, measured as ratio of the book value of short-term and long-term debt over the book value of total assets; *MB* denotes the market value of equity divided by book value of equity; *EPS* denotes earnings per share, calculated as earnings before extraordinary items deflated by number of outstanding common shares; *BV* denotes book value of equity, measured as the total assets less total liabilities, then deflated by number of outstanding common shares; *NEWS denotes* news forecast, identified as bad news with value of "1" if the sign of cumulative excess returns is negative and good news with value of "0" if the sign of returns is positive; and *IND* denotes industry dummy variables.
Bold format represent the Pearson correlation, which its values are significantly different at 5% or below, two-tailed *t-tests*.

Panel B of Table 3 presents the Pearson correlation coefficients for the test variables. The correlation between *MEFCAR* and the *C_SCORE* is significantly positive; the correlation coefficient of the *C_SCORE* is 0.662, which supports the prediction that there is a positive correlation between conditional conservatism and accumulated excess returns around the management earnings forecast disclosure dates.

4.3   Regression Analysis

To investigate the informational role of conservative reports and management earnings forecasts for capital markets, this section examines the effects of conditional conservatism on market reactions to management earnings forecasts. To test the research hypothesis, this study regresses cumulative market-adjusted returns around the management forecast date (*MEFCAR*) on conditional conservatism (*C_SCORE*) and control variables, as shown in Equation (3).

Table 4 reports the regression results of the research hypothesis. In this model, the industry dummy variables are included. The heteroscedasticity robust *t*-statistics are reported in the parentheses. The results show that the overall model is significant (*F*-value = 274.39, $p<0.000$). In addition, the model's explanatory power is high, as reflected by the adjusted R^2 of 67.78 per cent.

In the regression model, the coefficients on conditional conservatism are positive and statistically significant. As shown, the coefficient on the *C_SCORE* is significantly positive (coefficient = 0.178, *t*-statistic = 18.850, *p*-value<0.000). This suggests that better cumulative abnormal returns for firms are associated with a greater degree of conditional conservatism. The effect of conservatism is also economically significant. For instance, the improvement in the *C_SCORE* from the lowest to the highest decile is associated with an increase in the cumulative abnormal returns around management earnings forecast disclosure (*MEFCAR*) of approximately 21 per cent (in Figure 2). This is equivalent to 16 per cent of the stock price increase for the average sample firms (with mean *MEFCAR* equals to 1.670 per cent). Therefore, the empirical findings suggest that the cumulative abnormal returns are significantly higher for more conservative-reported firms, thus, supporting the hypothesis.

In terms of control variables, the coefficients on variables related to firm characteristics show that only the debt ratio (*DEBT*) and earnings per share (*EPS*) have signs that support the prediction of this study. The results find a significantly negative coefficient on the debt ratio

(coefficient = -0.260, *t*-statistic = -2.490). This means that firms with greater debt ratio tend to experience more negative cumulative excess returns. The result also indicates a significantly positive coefficient on earnings per share (coefficient = 0.002, *t*-statistic = 2.980) which is consistent with the argument that firms with larger earnings per share have better cumulative excess returns (Collins et al., 1997; Francis & Schipper, 1999).

Table 4 also illustrates the coefficients on the firm size (*SIZE*) are negative and statistically significant. The result is consistent with the notion that because large firms are more information-abundant, the reactions of the market are expected to be less forceful when these firms disclose information (Bamber, 1987). The coefficients on the news

Table 4: Cross-Sectional Regression of Cumulative Excess Return on Accounting Conservatism

Variables	Predicted sign	Coefficient (*t*-stats)
C_SCORE	+	0.178** (18.850)
SIZE	+	-0.002* (-1.180)
DEBT	-	-0.260** (-2.490)
MB x 1000	+	-0.068** (-2.470)
EPS	+	0.002** (2.980)
BV x 1000	+	-0.308** (-2.310)
NEWS	+/-	-0.098** (-21.92)
Constant		0.106** (4.480)
IND		Included
F-value		274.39
Sig.F		0.000
Adjusted R^2		67.78%
Observations		923

Note: C_SCORE denotes conservatism, estimated following the approach of Khan and Watts (2009); SIZE denotes firm size, measured as the natural logarithm of the market value of equity; DEBT denotes debt ratio, measured as ratio of the book value of short-term and long-term debt over the book value of total assets; MB denotes the market value of equity divided by book value of equity; EPS denotes earnings per share, calculated as earnings before extraordinary items deflated by number of outstanding common shares; BV denotes book value of equity, measured as the total assets less total liabilities, then deflated by number of outstanding common shares; NEWS denotes news forecast, identified as bad news with value of "1" if the sign of cumulative excess returns is negative and good news with value of "0" if the sign of returns is positive; and IND denotes industry dummy variables.
*and ** indicate statistical significance at the 10% and 5% level, respectively.

forecasts (*NEWS*) and the book value of equity (*BV*) are negative and statistically significant at less than the .05 level, making this inconsistent with the prediction of the study. The negative association between *BV* and the cumulative excess returns indicates that high-growth firms need to face public scrutiny in their forward-looking information disclosures, thus the reactions of the market are expected to be less forceful when these firms disclose information (Gong et al., 2009). The market-to-book ratio (*MB*) that is negatively associated with the cumulative excess returns thus, does not support the prediction of the study. Hence, the finding suggests that high-growth potential firms encountering higher agency problems have lower returns (Myer, 1977). Finally, the coefficients on the industry dummy variables are negative and not statistically significant. This implies that industries do not have the impact on variations in the firm's stock returns (the coefficients and *p-value* are not shown in Table 4 but available from the author upon request).

5. Additional Test

In addition to the *C_SCORE*, the cumulative non-operating accruals (*CONS_Accrual*) measure and the scaled decile rank of the *C_SCORE* were employed as measures of total conservatism and conditional conservatism, respectively, in support of the current test. The *CONS_Accrual* is the average non-operating accruals scaled by total assets over the preceding five years prior to the management earnings forecast disclosures (Givoly & Hayn, 2000; Beatty et al., 2008).

The results show that the positive coefficient remains highly significant (coefficient = 0.380, *t*-statistic = 4.640) when the measure of conservatism is the cumulative non-operating accruals. Furthermore, the coefficient on conservatism measure is significantly positive (coefficient = 0.290, *t*-statistic = 10.700) when the measure of conservatism is the scaled decile rank. Thus, the result holds for alternative measures of total conservatism and conditional conservatism, respectively.

6. Conclusion

This study has examined the effects of conditional conservatism on stock market reactions to management earnings forecast disclosure. It was hypothesised that firms with a greater degree of conditional conservatism would receive more positive stock price reactions when

they disclose their earnings forecasts. Using listed firms in Thailand, this study finds that a firm's degree of conditional conservatism is significantly and positively associated with its cumulative excess returns around the period when earnings forecasts are announced. The results support the existing financial disclosure literature and confirm the hypothesis that high earnings quality (i.e., conditional conservatism) and management voluntary disclosure (i.e., management earnings forecast) can complementarily influence stock market returns, consistent with Ball (2001) and Ball et al. (2012).

The empirical evidence drawn from this study adds to the current field of study through academic and managerial contributions. First, the study specified the additional economic benefit of conditional conservatism namely, an increase of confidence in the credibility of voluntary management forecast information, which can lead to positive stock market reactions. Secondly, this study provides adequate evidence that can be added into the pros-cons list of conditional conservatism. By investigating its informational role, conditional conservatism is found to have enhanced the ability of current earnings to predict future operating cash flows (Mora & Walker, 2015). However, there is a possibility that conditional conservatism may negatively affect earnings reliability which then diminishes the usefulness of current earnings (Bandyopadhyay et al., 2010). Hence, in practice, a trade-off between relevance and reliability of accounting information can be found when high conservatism is applied (Hellman, 2008).

The Thai Accounting Standard (TAS) has fully complied with the IFRS since the year 2005. Although conservative accounting policy was employed to weaken the harmful effects of moral hazard and adverse selection problems that are caused by the firm managers' self-serving motivation and information asymmetry, it is noted that in the situation of high uncertainty, managers can still apply their own judgments and discretions in disclosing information that may influence the credibility of earnings forecasts. Therefore, Thai regulators should be concerned about these issues when releasing accounting rules and disclosure rules for voluntary disclosure by listed firms in Thailand in the future. Further, it is useful for academic scholars and regulators to gain knowledge regarding the roles of reported financial information and voluntarily disclosed information especially for countries in emerging markets. Academic scholars and regulators should be concerned that information in emerging markets have been described as less efficient when compared to developed markets. Therefore, the credibility of

reported financial information and voluntarily disclosed information are critical issues.

A limitation of this study is that the disclosure of management earnings forecasts for listed firms in Thailand is voluntary. As these listed firms have voluntarily issued annual management earnings forecasts, the study does not include all listed firms with various degrees of conservative reports. Instead, the sample firms comprise of sufficient firms in each industry and the sample size is adequately large for regression analysis testing.

This study has provided additional empirical evidence which shows that increasing conditional conservatism in financial statements can enhance relevance as managements are committed to disclosing credible earnings forecast information. An interesting extension for future research is to investigate if the findings prevail in other countries in the ASEAN region. Since Thailand adopted the IFRS, the empirical findings focusing on the impact of conditional conservatism may also apply to other countries. In addition, as Ruch and Taylor (2015) and Mora and Walker (2015) noted, with respect to the implication for accounting policy-makers, the outcome of this study demonstrating empirical evidence which supports certain claims should encourage future researchers to examine the distinct effects of the timely recognition of loss and the delayed recognition of gains. While it is believed that results can bring important implications for policy-makers, studies on the effects of less timely recognition of gains is currently still sparse.

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