

The Philosophy of Accounting Conservatism: Pillars of Transparency and Corporate Responsibility

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ABSTRACT

This study investigates the role of accounting conservatism as both a technical tool and a moral framework in enhancing corporate transparency, stakeholder trust, and financial stability. It examines how the integration of moral values, such as prudence, transparency, and responsibility, reinforces accountability in financial reporting. This study employs a qualitative descriptive approach, analysing relevant literature and two illustrative cases—Enron and Lehman Brothers—to highlight the consequences of inadequately applying accounting conservatism and its moral dimensions. The study reveals that accounting conservatism, when applied ethically and strategically, mitigates risk, enhances transparency, and supports sustainable decision-making. However, excessive conservatism or manipulative practices, such as big bath accounting, can distort financial realities and undermine public trust. By integrating axiology and functionalism, this study offers a novel philosophical perspective on accounting conservatism as both a moral and technical foundation for building a transparent and sustainable financial system, contributing to the discourse on ethical corporate governance.

Keywords: Accounting Conservatism, Axiology, Corporate Responsibility, Moral Philosophy, Transparency



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INTRODUCTION

Building stakeholder trust and maintaining a strong reputation are among the most valuable assets for a company in sustaining its relationships with stakeholders. In practice, accounting conservatism enhances a company's reputation by providing reliable and trustworthy financial information, which helps maintain market stability. Over the past few decades, major scandals such as those involving Enron and Lehman Brothers have shaken global confidence in financial reporting. These incidents underscore the importance of applying accounting conservatism that is not only accurate but also grounded in moral values.

Accounting conservatism is one of the core principles in financial reporting, emphasizing the early recognition of losses and the delayed recognition of income. This principle aims to provide more realistic, prudent, and trustworthy financial statements (Zhong & Li, 2017). Beyond its role as a technical tool for risk mitigation, conservatism reflects moral values such as honesty, responsibility, and transparency. These values form an essential foundation for building public trust in financial statements and fostering economic stability. Amid growing business complexity and dynamic global economic conditions, the application of accounting conservatism has become increasingly relevant. However, while these principles can enhance transparency and accountability, their application without a moral foundation can lead to financial statement manipulation. This highlights the critical importance of values such as responsibility and transparency in financial reporting. A tangible example is seen in the Enron and Lehman Brothers scandals, where unethical financial statements undermined stakeholder trust and resulted in global economic instability. These cases emphasize the necessity of integrating moral values into accounting conservatism to prevent bias and ensure honest reporting. By embedding moral values, accounting conservatism not only enhances a company's reputation but also strengthens long-term relationships with stakeholders.

The urgency of this research arises from the need to understand how accounting conservatism can be applied ethically and effectively, rather than merely fulfilling the perception that it is a legal tactic used to beautify a company's financial statements. In the era of globalization and the internationalization of capital markets, companies face significant pressure to provide attractive reports for investors. Without a strong moral foundation, such pressure may foster manipulative practices, such as big bath accounting, which undermine accountability and transparency. This study explores the philosophical dimensions of accounting conservatism through an axiological framework, which emphasizes moral values, and functionalism, which focuses on the efficiency of reporting. It aims to examine how accounting conservatism can serve as a pillar of corporate transparency and responsibility by integrating moral values through these frameworks. To address this objective, the study employs a qualitative descriptive approach with case illustrations to highlight the role of moral values in building stakeholder trust and creating a sustainable financial system. Although accounting conservatism has long been discussed in the literature as a technical tool for risk mitigation and financial stability, previous research has often overlooked its moral dimensions, particularly regarding corporate transparency and responsibility. This research seeks to fill this gap by emphasizing the integration of moral values through axiological and functionalist perspectives. By combining these approaches, the study contributes to bridging the gap between the theory and practice of accounting conservatism. It also aims to dispel the sceptical notion that accounting conservatism is merely a legal tool for implementing a company's opportunistic strategies. Instead, it offers strategic insights for companies, auditors, and regulators to develop a more ethical and sustainable financial reporting system. This approach enhances transparency, strengthens public trust, and supports informed decision-making within both the internal and external sectors of a company.

The philosophy of science provides a theoretical foundation for understanding accounting conservatism as both a technical and moral tool. It serves as a critical framework for developing and refining thought systems across various disciplines, including accounting. There are three main pillars in philosophy of science that have always been guidelines, namely ontology, epistemology, and axiology (Abadi, 2016). In the context of conservative accounting, the philosophy of science helps to uncover the fundamental principles underpinning the practice of financial reporting. Through a philosophical lens, accounting conservatism can be examined from two key perspectives: axiology, which emphasizes moral values such as fairness and trust, and functionalism, which focuses on reporting efficiency and risk mitigation. Understanding these perspectives provides deeper insights into the role of conservatism in fostering a transparent and

sustainable financial system. Axiology, a branch of philosophy centered on moral values and the practical utility of knowledge for human life, derives from the Greek words "axis" (value) and "logos" (theory). Axiology explores the ethical and moral principles underlying scientific practices, including financial reporting. For instance, in the realm of conservative accounting, axiological principles help assess the extent to which values such as honesty and transparency form the foundation of financial reporting practices. Accounting conservatism, when guided by axiological values, can serve as either an empowering or a detrimental tool, depending on how those values are implemented. For example, a conservative approach that prioritizes the early recognition of losses may demonstrate honesty in addressing unrealized risks. However, if misapplied, this principle can mislead stakeholders and create biases that erode public trust. It is therefore essential to ensure that financial reporting reflects actual conditions by integrating moral values to maintain transparency and accountability. In axiological philosophy, morality is the cornerstone that enables financial reporting to function as a mechanism for building trust. As affirmed by Suriasumantri (Abadi, 2016), the knowledge and power possessed must be used for the common good, not to exploit the weaknesses of the system. In this regard, accounting conservatism transcends its technical role, becoming a profound reflection of morality to balance stakeholder expectations with financial realities. By emphasizing values such as fairness and trust, axiology provides a robust foundation for the practice of accounting conservatism, thereby supporting the sustainability of the economic system.

Functionalism is a paradigm that views social and economic systems as structures designed to maintain stability, efficiency, and balance. In the context of conservative accounting, functionalism explains how the prudential principle fosters efficient reporting and mitigates risk. (Burrell & Morgan, 2019) in *Sociological Paradigms and Organizational Analysis*, explain that functionalism believes in the order of the social world and the role of each element in maintaining the balance of the system. In this context, conservatism acts as a controlling mechanism that supports the stability and sustainability of the economic system. The principle of functionalism is often applied in accounting approaches that rely on large archival datasets and empirical analysis. (Lukka, 2010) revealed that modern accounting research is often influenced by functionalist paradigms based on economics. This approach prioritizes stability, regularity, and rationality in financial reporting. However, Lukka also criticized how functionalism can limit innovation and constrain the exploration of more complex accounting phenomena. While the functionalist paradigm helps companies focus on efficiency and risk mitigation, it must be accompanied by critical reflection on its impact on accounting innovation. In practice, functionalism significantly contributes to helping companies achieve their financial objectives. For instance, by adopting conservative principles, companies can avoid major risks by accelerating the recognition of losses and delaying the recognition of income. This approach creates a balance in financial statements, ensuring that the economic system remains efficient and functions effectively. However, to achieve optimal results, the application of functionalism in accounting must be paired with a flexible approach that considers not only efficiency but also broader moral values. In this context, axiology and functionalism provide complementary perspectives for understanding accounting conservatism. Axiology emphasizes the importance of moral values such as honesty, fairness, and trust in ensuring transparent and accountable financial reporting. Conversely, functionalism offers a framework for maintaining the efficiency and stability of the financial system through risk mitigation and structured control as a form of corporate moral responsibility. By integrating these two approaches, accounting conservatism can be applied in a balanced manner, achieving not only technical efficiency but also reflecting moral responsibility toward stakeholders.

Accounting conservatism is an approach in financial reporting that emphasizes the adoption of conservative accounting principles. These principles prioritize the selection of the most prudent or least favourable policy for the company in conditions of uncertainty or doubt in estimation and

measurement. The theory of accounting conservatism assumes that investors and creditors are more comfortable receiving low- risk financial information and prefer to see a company's performance through cautious and measured reporting (Hong, 2020)(Laux & Ray, 2020). As one of the core principles in financial reporting, accounting conservatism aims to enhance corporate transparency and accountability. This principle emerged in response to the need for prudent financial reporting in the face of economic uncertainty, especially within the context of globalization and the internationalization of capital markets. By emphasizing the early recognition of losses and delaying the recognition of income, conservatism fosters public confidence in a company's financial statements. (Shroff et al., 2013) explains that accounting conservatism has been applied since the 15th century in commercial partnerships. They define conservatism as "profits that reflect bad news faster than good news" and use changes in the estimated amortization period of fixed assets as an illustration. However, this approach has been criticized by (Dietrich et al., 2007), which highlights the bias in the statistical method of measuring conservatism. According to their findings, these biases stem from study designs, such as the use of truncated sample distributions, which can produce inaccurate results. Despite these criticisms, this perspective enriches the discussion on how conservatism is understood and applied in modern contexts. (Watts, 2003) Identify conservatism as an important principle in risk mitigation recognized by accounting regulators. Watts attributes the importance of conservatism to various factors, such as contractual obligations, shareholder litigation, taxation, and accounting regulations. He emphasizes the critical part of asymmetric verification in fiscal reporting and lawyers for institutions similar as the Securities and Exchange Commission (SEC) and the Financial Accounting norms Board (FASB) to admit the nonsupervisory counter accusations of traditionalism.

Moreover (Ahmed et al., 2012) demonstrate that conservatism helps reduce conflicts between shareholders and management through a more measured dividend policy. By adopting a market-based and accrual approach, conservatism contributes to lowering corporate debt costs, strengthening financial stability, and improving reporting efficiency. Overall, accounting conservatism is not merely a technical principle but also a strategic tool for addressing uncertainty and risk in financial reporting. With its long history and continued relevance in modern practice, conservatism remains a vital topic in promoting corporate transparency, accountability, and stability. As a principle of prudence, accounting conservatism functions not only as a technical framework but also as a reflection of moral values, such as transparency and responsibility, which are explored further in its moral dimension.

Transparency is a fundamental element of financial reporting, ensuring that information provided to stakeholders is accurate, relevant, and timely. Accounting conservatism promotes the disclosure of risks and uncertainties, including contingent liabilities, lawsuits, and changing market conditions. By ensuring compliance with accounting standards and regulations, conservatism fosters stakeholder trust and provides a robust foundation for informed investment decision-making. Additionally, conservatism embodies moral values such as prudence and responsibility. The prudential principle underscores the importance of anticipating potential losses or liabilities by recognizing only realized profits. This approach ensures the reliability of financial information, thereby enhancing transparency and accountability in reporting. Ethics also play a pivotal role in safeguarding the integrity of financial statements. Shareholders, creditors, and the general public depend on accurate and transparent information to make well-informed decisions. Consequently, accountants bear a moral responsibility to adhere to ethical standards, ensuring that financial statements are prepared with honesty and diligence. Conservatism supports this ethical commitment by emphasizing potential risks and liabilities while providing stakeholders with reliable information. However, conservatism is not without its criticisms. In certain cases, overly conservative reporting can lead to information that is excessively pessimistic or lacks neutrality,

potentially hindering a company's ability to attract investors. Therefore, achieving a balance between conservatism and neutrality is essential to ensure financial reports remain transparent and reliable. By integrating moral values, accounting conservatism remains a relevant and indispensable principle in fostering ethical and sustainable financial reporting practices.

METHODS

This study uses a qualitative approach through a literature review to explore the relationship between accounting conservatism, moral values, and economic stability. This approach was chosen because it allows researchers to understand complex phenomena and provides insights into how accounting principles can be applied in moral and ethical contexts. The design of this study adopts a Systematic Literature Review (SLR). The SLR approach was chosen to ensure a structured and comprehensive review of the literature, allowing for an in-depth understanding of complex phenomena and providing insights into how accounting principles can be applied in moral and ethical contexts. The design of this study integrates a theoretical framework with illustrative case studies, with practical examples to explain and support the proposed concepts drawn from two real cases: Enron and Lehman Brothers. These cases were selected as they represent significant examples of failures in implementing accounting conservatism and their subsequent impact on public trust and financial stability.

Data for this study were collected using source triangulation, encompassing leading academic journals, foundational reference books on accounting conservatism, and detailed case reports. Journals were accessed via platforms such as Google Scholar, Garuda Portal, and Scopus, ensuring a robust selection of peer-reviewed studies from the past two decades. The literature review focuses on the ethical, economic, and regulatory dimensions of accounting conservatism, along with case studies illustrating both successful and unsuccessful implementations. Reference books provide theoretical insights into the fundamental principles of accounting conservatism, while case reports on Enron and Lehman Brothers offer practical illustrations of its misuse. The analysis employed a narrative analysis approach, involving a systematic review of prior studies to identify key concepts in the literature and analyze data through the lenses of axiology and functionalism. These perspectives are illustrated using real-life cases to examine the relationship between accounting conservatism, transparency, and corporate responsibility.

This methodological design provides a robust foundation to address the key research question: How can accounting conservatism serve as both a technical tool and a reflection of moral values? The findings explore the moral and functional dimensions of accounting conservatism and its contributions to financial stability. By integrating a qualitative literature review with illustrative case studies, this study not only strengthens the validity of its findings but also contributes significantly to understanding the moral dimensions of accounting conservatism and its implications for financial sustainability.

RESULTS AND DISCUSSION

Philosophy of Accounting Conservatism

Accounting conservatism focuses on early recognition of losses and delayed recognition of income. This approach ensures more realistic and trustworthy financial reporting, reflecting moral values such as prudence, transparency, and responsibility. Accounting conservatism provides significant benefits in building trust and reliability in financial statements. By acknowledging losses early, conservatism helps reduce the risk of overstatement, thereby playing a crucial role in supporting the stability of the company's operations by providing more reliable information (LaFond & Watts, 2008). In the realm of moral philosophy, this principle can be understood

through axiology, which underscores the importance of ethical values in decision-making, and functionalism, which highlights the role of financial reporting in maintaining the stability and efficiency of the economic system. Axiology demonstrates that accounting conservatism is not merely a technical exercise but also reflects a company's moral responsibility to its stakeholders by ensuring transparency in financial statements. Conversely, functionalism emphasizes how accounting conservatism prevents financial turmoil by ensuring that financial statements accurately reflect potential risks, ultimately contributing to financial stability and the company's long-term viability. Through this dual perspective, conservatism emerges as a strategic tool for fostering financial sustainability within organizations and the broader economic system.

However, the excessive application of conservatism also has potential weaknesses that can harm a company's reputation and create negative impacts. According to (Scott, 2015) In his book "The Financial Accounting Theory" outlines the concept of over- conservatism, which portrays an overly pessimistic financial outlook. This can hinder a company's access to new funding and give a negative signal to the market. Additionally, manipulative practices such as big bath accounting, where losses are deliberately exaggerated to improve future performance, result in inaccurate and misleading information, thereby damaging perceptions of the company's performance. For instance, tech companies that delay revenue recognition from licensing contracts may create the impression of being less competitive, even though the reality may differ. Achieving a balance between prudence and transparency is essential to ensure that conservatism provides its intended benefits without harming the company's reputation. From an axiological perspective, conservatism reflects moral values such as fairness, responsibility, and transparency, which are critical for creating ethical and trustworthy financial reporting. These values ensure that financial statements accurately reflect reality without sacrificing precision or creating excessive bias. Conversely, functionalism views conservatism as a tool for maintaining economic stability through risk mitigation and reporting efficiency. This principle supports the financial system's stability by providing a realistic depiction of a company's financial health. However, when over- conservatism is applied, it can create detrimental biases, such as unnecessary delays in revenue recognition, which may reduce a company's competitiveness. This reflection highlights the importance of applying conservatism with a careful balance between prudence and transparency. When applied appropriately, these principles not only uphold moral values but also contribute to the stability and sustainability of the financial system as a whole.

Pillars of Transparency and Corporate Responsibility

The moral dimension of accounting conservatism ensures that these principles are applied ethically and responsibly, rather than being used as a tool for manipulation. Strict supervision and auditing are essential to prevent the misuse of conservatism, such as in big bath accounting practices. In practice, achieving a balance between prudence and transparency should be tailored to the specific needs of each industry. For instance, the technology sector requires conservative flexibility to account for the dynamic nature of its intangible assets. Rigorous audits ensure that conservatism is applied to create transparent and accurate financial reporting, prioritizing fairness and moral responsibility. This approach fosters ethical reporting practices that safeguard stakeholder interests. Furthermore, from a functionalist perspective, conservatism plays a crucial role in maintaining the stability of the financial system without introducing excessive bias. With a balanced and ethical approach, accounting conservatism can serve as a powerful tool for building public trust, preserving corporate credibility, and fostering long-term financial sustainability.

Case Illustration

The case of Enron and Lehman Brothers illustrates how the neglect of moral values can undermine public trust and financial stability. Enron, founded in 1985, and as one of the world's leading electrical, natural gas, communications, and pulp and paper industries. Before its bankruptcy in

late 2001, Enron's annual revenue skyrocketed from approximately \$9 billion in 1995 to more than \$100 billion in 2000. At the end of 2001 it was revealed that the reported financial condition was largely supported by institutionalized, systematic, and creatively planned accounting fraud. The company's stock price plummeted from \$90 per share in mid-2000 to less than \$1 per share by the end of 2001, causing shareholders to lose nearly \$11 billion. Enron subsequently revised its financial statements for the preceding five years, uncovering a loss of \$586 million, and ultimately filed for bankruptcy on December 2, 2001 (Li, 2010). Still in Enron's case, Enron's fraudulent activities were heavily tied to its use of special purpose entities (SPEs) to hide \$30 billion in debt, creating an illusion of profitability that was unrealistic and misleading (Healy & Palepu, 2003). These transactions share ownership of cash flows and certain risks with outside investors and lenders. Traditional accounting practices, which rely on reasonable transactions between independent entities, faced significant challenges in addressing such complex arrangements. By October 2001, Enron's issues had worsened due to the company's acknowledgment that several new business ventures were underperforming. The company announced a series of asset impairments, including an after-tax expense of \$287 million for Azurix, a water business acquired in 1998, \$180 million for broadband investments, and \$544 million for other investments (Healy & Palepu, 2003).

Enron's actions serve as a tangible illustration of the consequences of over-conservatism and its improper application. Such practices can diminish investors' perceptions of a company's prospects, hinder access to new funding, and send misleading signals to the market, even when the company possesses high growth potential. As a result, investor confidence was shattered, ultimately triggering Enron's bankruptcy in 2001. This case provides practical insights into the critical role of morality in accounting conservatism. When applied with moral values such as transparency and responsibility, conservatism can build public trust, enhance accountability, and promote long-term financial stability. Furthermore, it strengthens corporate relationships with stakeholders, positively impacting the broader public interest. Conversely, neglecting moral values in the practice of accounting conservatism risks creating biases that undermine the integrity of financial statements and erode public trust. This highlights the necessity of achieving a balance in the application of conservatism to ensure transparency without sacrificing financial reality.

Another illustration of the neglect of moral values in accounting conservatism can be seen in the fall of Lehman Brothers, once the fourth-largest investment bank in the United States. Before its collapse, Lehman operated across major business areas, including general investment banking, equity, fixed income, capital markets, and investment management. Its investment banking division provided financial services such as mergers and acquisitions, underwriting, and securities issuance. Meanwhile, its equity division invested globally, and its fixed income and capital markets divisions offered a wide range of services, including wealth management. Their main income comes from fees earned from the size of the transactions or services provided (Shirakawa, 2021). A similar practice of neglecting moral values was evident in Lehman Brothers' use of a creative but fraudulent accounting method known as Repo 105. This technique was employed to manipulate its financial position and present a healthier balance sheet than was accurate. (Azadinamin, 2012) quoting Jeffers, defines Repo 105 as "an aggressive and deceptive off-balance sheet accounting device used to temporarily remove securities and non-performing liabilities from Lehman's balance sheet while reporting quarterly financial statements to the public". Lehman used Repo 105 to improve its balance sheet image by temporarily removing approximately \$50 billion of assets from its balance sheet by recording the value of the loan as a sale at the end of the first half of 2008, with this accounting treatment Lehman Brothers avoided recording any liabilities when receiving cash. stated that the use of Repo 105 makes the Company appear to have good capital and low leverage, with sufficient liquidity to meet its short-term obligations. Liabilities and with profitability and good utilization of assets. With this changing economic situation, Lehman

Brothers is trying to receive more loans from financial institutions (Siskos, 2013). Although as mentioned Repo 105 is a legal procedure, Lehman uses it in an unusual and unethical way to acquire new assets. Accounting standards pave the way for unethical managers to take advantage of these standards and put them into practice as they see fit (Azadinamin, 2012) unethical behaviour. Accounting standards should be modified to inhibit unethical behavior and wrong practices that can harm one's wealth.

The Lehman Brothers case clearly illustrates the moral neglect in the application of accounting conservatism. The company manipulated its financial statements to hide short-term obligations and present a more stable financial position than reality. By failing to adhere to applicable accounting standards and recording loan transactions as sales, Lehman Brothers violated the essence of accounting conservatism (Azadinamin, 2012). This manipulation ultimately led to the company's bankruptcy in 2008, becoming one of the primary triggers of the global financial crisis. Cases like Enron and Lehman Brothers demonstrate how the improper enforcement of accounting conservatism can tarnish reputations, destroy public trust, and contribute to financial crises. Therefore, accounting conservatism must be applied with balanced prudence, reflecting moral values such as responsibility and transparency. Within this context, accounting conservatism plays a strategic role in fostering trust through transparency and accountability. However, the current literature remains limited in addressing the relationship between morality and accounting conservatism.

CONCLUSION

Accounting conservatism is not merely a technical framework in financial reporting but also serves as a strategic reflection of moral values, such as prudence, transparency, and responsibility. When applied ethically and in balance, it can strengthen corporate accountability, foster public trust, and support long-term financial stability. However, an unbalanced application, such as over-conservatism or manipulative practices like big bath accounting, can undermine the integrity of financial statements and erode public confidence.

This study, while insightful, is limited in scope as it primarily focuses on failures in implementing accounting conservatism, with case illustrations centered on Enron and Lehman Brothers. These limitations restrict the generalizability of findings across different industries and regions. Furthermore, the absence of quantitative data from companies that have successfully applied conservatism ethically narrows the analysis of its positive impacts. Future research should explore diverse case studies, incorporate quantitative data, and adopt multidisciplinary approaches to enrich understanding and broaden the applicability of accounting conservatism. To address these challenges, this study offers practical recommendations, including enhanced supervision by auditors and regulators, the development of flexible reporting standards tailored to industry needs, ethics-focused education and training for accountants, and the integration of technology to ensure transparent and reliable financial reporting. These measures aim to strengthen the ethical and efficient application of accounting conservatism across sectors.

Ultimately, the integration of moral values into accounting conservatism is essential for building a more transparent, ethical, and resilient financial system. By doing so, companies, regulators, and stakeholders can collectively foster public trust, uphold accountability, and contribute to sustainable economic stability in an increasingly complex financial environment.

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