Studying of the effect of systematic risk on accounting conservatism evidenced from Iran

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Abstract: There is a risk with any opportunity and we can not remove all risks. Also regarding the fact that in higher systematic risk management less conservative approaches are used strategically, in the present research we are going to study the effect of systematic risk on conditional and unconditional conservatism in firms accepted in Tehran Stock Exchange. To determine the systematic risk we have used the market model and to calculate conditional and unconditional conservatism we have used the models posed by Ball, Shiva Komar, Giuli&Hyne. 90 firms accepted in Tehran Stock Exchange in the time period between 2007 and 2011 were investigated in this study. To test the hypotheses, we have used the linear regression model. The findings of the research showed that systematic risk has a meaningful and positive effect on conditional and unconditional conservatism. [noorifard Y, Afshari J, Ahmadzadeh Y, Maghsoudi, O. **Studying of the effect of systematic risk on accounting conservatism evidenced from Iran**. *Life Sci J* 2013; 10(5s):51-57] (ISSN: 1097-8135). <u>http://www.lifesciencesite.com</u>. 9

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1. Introduction

The faster identification of profits and the postpone of losses is considered as one of the opportunistic behaviors of the managers, because they can increase the amount of rewards appropriated for them by doing this and it is called management reward hypothesis in positive theory literature (Raee&Khosravi, 2007). Accordingly Lafound& Watts (2008) believed that conservatism is a halting factor for extra-optimistic managers. Walk & et al (2004) considered the time asymmetry in identifying the assets and profits and describe conservatism as: "the sooner identification of losses and measuring the assets the less". On the other hand, Francis & Martin (2010) found out that the investors opt to increase the yield of their investment, but when the systematic risk is high the use of time asymmetry by the management will result in the limited distribution of the assets and stocks profit among the investors.

Kotari& et al (2009) found that strategic management postpones the bad news and announces good news earlier. Also they understood a higher systematic risk in an economic structure creates the probability of gaining a vast range of future positive performance. Although the investment return reduces in short-term, it is not the same for long-term investment. Thus, a higher systematic risk creates more motives for the mangers to be less conservative in the current period. Regarding the importance of systematic risk and its relation with conditional and unconditional conservatism, the present research will deal with studying the effect of systematic risk on conditional and unconditional conservatism. We will try to answer this question: "Does systematic risk affect conditional and unconditional conservatism or not? And if the answer is yes, what is the effect of this relationship?

2. Review of the related literature

Brimbel (2003) studied the role of accounting information in systematic risk estimation. In the research including accounting beta, profit changes, growth, size, profit payment ratio, current ratio, financial leverage, interest coverage ratio and operational leverage, it was found that the accounting variables above identify more than %57 of systematic risk changes. Balachendran&Mohtroom (2004) studied the relationship between conservatism and data content. They measured conservatism biased downward in book values and time asymmetry of the earnings by using an approach developed by Penman &Jhang (2002) and Basoo (1997), but they didn't find any evidences showing that there is a relationship between conservatism (conditioned or nonconditioned) and data content. In fact, they found some evidences that showed it is not reasonable to say there is a relationship between conservatism and data content in accounting.Karimzadeh (2004) studied the analytical relationship between systematic risk and capital cost in firms accepted in Tehran Stock Exchange. In his research, the ratio of total liabilities to owners' equity is considered as the financial leverage and beta coefficient is considered as the systematic risk index. He concluded that there isn't any meaningful relationship between financial

leverage and systematic risk.Mashayekhi& et al (2009) studied the relationship between conservatism and the amount of profit and profit consistency. They found out regarding the theoretical fundamentals posed before in agency theory that by increasing conservatism the distribution of dividends decreases, but conservatism does not affect profit consistency meaningfully. Rahmani&Gholamzadeh (2009)studied the difference between conservatism in the two periods of before and after inclusion of their names in the list of prices in Tehran Stock Exchange. Generally their aim was to study the effect of public ownership in capital market on conservatism in financial reporting. They found that conservatism decreases in financial reporting of the companies after the inclusion of their names in the list of prices in Stock Exchange. Garcia & et al (2010) studied the relationship between conditioned conservatism, systematic risk and capital cost during the years between 2001 and 2006. They found out that conditioned conservatism has a negative effect on systematic risk and capital cost because conservatism can decrease the lack of absoluteness related to market estimations of cash flows. John Chi (2011) studied the relationship between conservatism and systematic risk. He used two types of conservatism as conditional and unconditional conservatism and identified two types of systematic risk as desirable and undesirable systematic risk and found out that generally the systematic risk (desirable and undesirable) has a negative effect on conservatism (conditioned and non-conditioned). He also remarked that the results of his research accords with those of Jensen & et al (1987).

3- Theoretical Framework and Research Hypotheses

The concept of risk plays a key role in financial markets. Thus, it should be recognized and measured. Risk isn't a negative phenomenon necessarily. There is a risk following every opportunity and we can not remove all risks because most of the opportunities will be lost either (Cark Elson, 2002). Regarding the categorizations done about the risks in different books, risk is divided into two main categories. The first group of the risks which are derived from the fluctuations in currency rates, political risks and ... is called systematic or inevitable risks. And the second group of risks which affect one or several certain bonds such as credit risk, business risk or ... are called non-systematic or avoidable risks (Moosavi&Keshawarz, 2011).

On the other hand the fast identification of bad news compared to the good news which finally result in conservatism increases the debt cost of the company and this cost is higher when there is a high systematic risk (Beiti, 2008). As it was posed earlier and regarding the theory suggested by Lafound& Watts (2008) conservatism is considered as a halting factor by those managers who are extra ordinarily optimistic because one of the opportunistic behaviors by the managers is the rapid identification of the profits and postponing the losses to increase the reward they deserve. According to Basoo (1997) conservatism is the obligation to have a high degree of approve to recognize the good news such as profit compared to the bad news. This description identifies conservatism regarding the profit and loss perspective (Banimahd&Baghbani, 2009).

In recent researches there has been a new categorization for conservatism which is called conditional and unconditional conservatism. Conditioned conservatism (post-incidental) is to recognize bad news about profit on time compared to the recognition of good news. For example, the least cost principle or market value, the omission of key money following the test of value decrease and the asymmetrical recognition of probable losses compared to probable profits (Bior&Rayan, 2005). Non-conditioned conservatism (ante-incidental) is derived from the utilization of those accounting standards which reduce the profit in way different from the current economic news. For example, the immediate identification of costs resulted from advertisements and research and development as the cost, even if when the future cash flows expected are positive (ibid). Jensen & et al (1976) studied whether systematic risk affects non-conditioned conservatism or not? They concluded that first the systematic risk has a reverse effect on conservatism and second the tendency of the management to avoid the spread of bad news stems from two reasons as: 1- because managers have more information then outsiders and their preferences do not accord with the beneficiaries' preferences and this is caused by agency problems and 2- it is done due to the rewarding and the survival of the managers in a company (John Chi, 2011). The previous researches have gathered some evidences which talk about the low quality of accounting and higher capital cost with higher systematic risks (Francis & et al, 2004). Kotari& et al (2009) concluded that the strategic management uses a less conservatism approach, but when the systematic risk is higher, a more stimulus is supplied for the managers who have been less conservatism during the current period. In the present research the following hypotheses were designed to answer the main research question based on the literature and the theoretical fundamentals posed about the role of systematic risk in reducing conservatism.

First hypothesis: Systematic risk affects conditioned conservatism.

Second hypothesis: Systematic risk affects unconditional conservatism.

4. Population and Statistical Sample

- 1. To select an appropriate statistical sample the following conditions were taken into consideration:
- 2. To observe the comparability of the samples, the fiscal year ended on the 29th of Esfand (20th of March) every year.
- 3. During the research's time period, they shouldn't have quitted or changed their fiscal periods.
- 4. All information needed about the companies should be accessible.
- 5. The companies shouldn't be banks or financial institutions (investment companies, financial intermediaries, holding companies or leasing).

Thus, regarding the limitations above, 90 companies were chosen during the time period

Conservativeness index =
$$\left(\frac{\text{Operational accrual commodities}}{\text{total assets at the start of the period}}\right) * -$$

Where, the operational accrual commodities are resulted by calculating the difference between net profits and operational cash flows plus depreciation cost. Guili&Hyne (2000) believe that the growth of accrual commodities can be an index showing the change in accounting conservatism degree during a long term period.

The reasons to choose the models above to measure accounting conservatism are as follows:

A: The present models for measuring conservatism such as Basoo (1997) and penman & Jhang (2002) which have also been used in some local researches encounter a lot of errors in measuring conservatism.

B: The data of the model used in this research is based on accounting data and market indexes are not used in it. Regarding the accessibility of the financial statements' data to measure the hidden conservatism in financial statements, these variable is conditional and unconditional conservatism. To calculate these variables we have used the models posed by Ball & Shiva Komar (2005) and Guili&Hyne (2000).

5-2. Conditioned conservatism:

 $TACC_{it} = \alpha_0 + \alpha_1 DCFO_{it} + \alpha_2 CFO_{it} + \alpha_3 DCFO_{it} * CFO_{it} + \varepsilon$ TACC_{it}= Total Accrual Commodity

 CFO_{it} = Cash Flows resulted from Operations DCFO_{it} = It is an artificial variable that equals to 1 when CFO is negative, otherwise it equals zero. between the years 2007 and 2011 to be included in our statistical society.

5. The models related to hypotheses' test

In the present research and regarding the effect of systematic risk on conditional and unconditional conservatism, the dependent research

All the variables included in the formula above were de-measured of the total assets by the residuals in the beginning of the period. The role of accruals in reducing the disturbances which can be created due to the operational activities were reflected in $a_2 < 0$. Conservatism or the in time recognition of losses results in $a_3 < 0$. Thus, in this model the coefficient a_3 is an index for conservatism (Ball & Shiva Komar, 2005).

5-1. Unconditional conservatism:

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Two models are more appropriate than other models for the markets in developing countries such as Iran (Banimahd, 2006).

5-3. Systematic risk

The systematic risk is the independent variable in this research. Because we have tried to calculate the index of systematic risk companies stocks in this research, it is necessary to use market model to calculate a bond (created by William Sharp, 1964) utilized by John Chi (2011) and Moosavi&Keshavarz (2011), in the overall form as follows:

$$R_{it} = \alpha_i + \beta_i * R_{mt} + \varepsilon_{it}$$

 R_{it} = Return of i company's bond in the year t

 R_{mt} = Return of market portfolio in the year t

 $\alpha_i = i$ Company's fixed amount in the year t

 β_i = Beta regression coefficient of i company in the year t

 ε_{it} = Random error items (resulted from sampling) of i company in the year t

 β_i reflects the regression slope relationship above which is calculated as follows:

$$\beta i = \frac{\text{cov}(\text{ri,rm})}{\delta^2(rm)} \quad) 1$$

Where, r_i is the average return of the company, r_m is the average return of the market, and θ^2 (rm) is the return variance of the market.

5-4. Control variables

Also based on the researches carried out in Iran some controlling variables were taken into consideration as follows:

5-4-1. Firm size:

It is calculated by the natural logarithm of total assets of the end of the period. Zimmerman (1983) stated that bigger companies exert more conservatism, due to the existence of more political sensitivities (political cost theory). In the present research and following the researches carried out in the field, we could use two variables as the criteria for firm size. Drashid & Jhang (2003) used the natural logarithm of the total assets of the end of the period and Zimmerman (1983) used the logarithm of total sales' income as the index of firm size. But in the present research we have used the natural logarithm of the total assets for firm size (Canno Rodriguez, 2011).

5-4-2. financial leverage:

This variable is calculated by dividing total liabilities to total assets of the end of period. Accounting methods are related to financial leverage

Variable	RISK	CONSER(c)	CONSER(u)	SIZE	LEV	GROWTH	MBV	ROA	
Ν	450	450	450	450	450	450	450	450	
Mean	0.647	0.966	-0.027	5.621	0.731	0.054	12.48	0.045	
Std. Deviation	0.228	0.409	0.163	0.568	0.788	0.108	1.497	0.191	
Skewness	0.56	0.81	0.93	-1.01	0.36	0.22-	0.56	0.10-	
Minimum	0.103	1.210-	1.339-	4.009	0.076	0.0106	9.059	0.193-	
Maximum	2.356	2.427	1.008	7.659	9.990	1.236	16.833	2.076	

Table 1. The Variable

5-4-4. Market value to book value:

This variable is calculated by dividing the market value of stocks of a company at the end of the year into the book value of owners' equity. The increase of market value compared to the book value is due to not recording some of the profits or recording the losses more than what is real. This can reduce the profit and thus it ends with an increase in conservatism (ibid).

5-4-5. Assets' return rate:

This variable is calculated by dividing net profit to total assets at the end of the period. Assets' return rates are used in managers' reward contractions clearly or implied. There are a broad amount of evidences of revealed use of the annual rewarding of long-term performance designs of the managing directors of the companies. The implied use of return of assets' rate criterion to assess board of directors and rewarding the top managers is related to the assets' return rate criterion and different payments to managers' criteria. Watts (2003) believes that the managers of companies which have rewarding programs are avoiding conservative methods more often. Accordingly if a part of the profits of managers is related to accounting profits (the numerator of assets' return rate), the management of companies

because the ratio of companies' liabilities is one of the criteria noticed by the creditors (in Iranian banks). Thus, the higher amount of liabilities of the companies, there is more tendencies to use less conservative methods. As a result, it is expected that managers of the firms exert less conservatism in their financial statements to reduce the probability of not acceptance of the loan application and avoiding impose of higher interest costs (Hassas-e-Yeghaneh & Shahriari, 2010).

5-4-3. the ratio of assets' growth:

This variable is calculated by the measurement of the difference of assets compared to the beginning of the period. The increase of assets at the end of the period compared to the beginning of the period occurs as a result of fixed assets' purchase. The purchase of fixed assets also results in more depreciation costs and thus the reduction of the presented profit (ibid).

will tend to use non-conservative methods. The following table shows the symbols of variables and their names.

 Table 2 :Symboland variables nameof research

Symbol	variables name
RISK	systematic risk
CONSER(c)	Conditioned conservatism
CONSER(u)	Conditioned unconservatism
SIZE	Firm size
LEV	Financial leverage
GROWTH	The ratio of assets' growth
MBV	Market value to book value
ROA	Assets' return rate

6. Research Findings

6-1. Explanatory findings

The descriptive statistics of independent, dependent and controlling variables are presented in the following table.

6.2. Empirical results

To study the normality of the variables and their remaining we have used Kolmogorov-Smirnov test. If the probability amount of this test is more than 0.05, we can approve the normality of variables' distribution with an assurance level of %95 and vice versa. The results of this test were shown in table (3) and it is clear that all qualitative variables of the research have a normal distribution. As it can be

seen, the probability amount of each of the variables is more than 0.05. Thus, we can test the data through the parametric tests.

Variables	RISK	CONSER(c)	CONSER(u)	SIZE	LEV	GROWTH	MBV	ROA
Kolmogorov- Smirnov Z	1.340	0.257	0.188	0.037	0.201	0.110	0.494	0.438
Sig.	0.098	0.113	0.276	0.752	0.163	0.451	0.121	0.101

Pearson's correlation matrix test is a test to determine the correlation amounts between the data. For example, in table (4) and with an assurance level of %95, there is a positive and meaningful relationship between conditional and unconditional conservatism. This relationship with the correlation coefficient of Pearson's test shows a positive relationship between conditional and unconditional conservatism %020.

Table 4: Pearson correlationcoefficient	
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Variables	CONSER(c)	CONSER(u)	RISK	SIZE	LEV	GROWTH	MBV	ROA
CONSER(c)	1							
CONSER(u)	0.020*	1						
RISK	0.115*	0.252*	1					
SIZE	0.163*	0.112*	0.078-	1				
LEV	0.009	-0.040	0.134*	-0.218*	1			
GROWTH	0.029	-0.027	0.112*	0.496*	0.001	1		
MBV	0.014	0.054	0.016	0.164*-	-0.010	0.006	1	
ROA	-0.136*	0.055	-0.082	0.480*	0.052-	0.891*	-0.037	1

The outputs resulting from the first and second hypotheses are as follows:

Regarding table (5) the systematic risk affects conditioned conservatism meaningfully. Because the amount of F equals 11.102 and its meaningfulness (P-value) level is less than %5, we can say that the regression model has the identification ability and also the meaningfulness level of the systematic risk (independent variable) and is less than 5 percents. Thus, by considering the

independent coefficient variable we can say that the systematic risk has a positive and meaningful effect on conditioned conservatism. Also because binocular Watson's test was calculated to be between 1.5 and 2.5, we can conclude that there isn't a self correlation between the variables. Additionally the amount of correlation coefficient shows that the changes in independent and controlling variables have shown a %66.7 change in the dependent variable.

R^2	R	D-W	P-value	F	Sig.	Т	Coefficient of Regression	research variables
0.405 0.667 1.769 0.00				0.00	4.220	0.117*	RISK	
			0.00	6.207	0.324*	SIZE		
	1.769	769 0.00	11.102	0.328	1.190	-0.019	LEV	
				0.917	0.104	0.299	GROWTH	
					0.267	1.117	0.003	MBV
					0.009	4.778	-0.230*	ROA

Table 5:	The results	of first	hypothesis	test
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Regarding table (6) the systematic risk affects non-conditioned conservatism meaningfully. Because the amount of F equals 12.154 and its meaningfulness (P-value) level is less than %5, we

can say that the regression model has the identification ability and also the meaningfulness level of the systematic risk (independent variable) and is less than 5 percents. Thus, by considering the

independent coefficient variable we can say that the systematic risk has a positive and meaningful effect on non-conditioned conservatism. Also because binocular Watson's test was calculated to be between 1.5 and 2.5, we can conclude that there isn't a self

correlation between the variables. Additionally the amount of correlation coefficient shows that the changes in independent and controlling variables have shown a %69.5 change in the dependent variable.

R^2	R	D-W	P-value	F	Sig.	Т	research variables	research variables
0.406 0.695 1.770				0.00	4.657	0.134*	RISK	
			0.00	6.945	0.206*	SIZE		
	1 770	0.00	12.154	0.246	1.168	-0.007	LEV	
				0.870	0.101	0.831	GROWTH	
					0.272	1.105	0.001	MBV
					0.004	3.947	-0.495*	ROA

 Table 6: The results of secondhypothesis test

7. Summery and Conclusion

The goal of the present research is to identify the effect of systematic risk on conditional and unconditional conservatism in firms accepted in Tehran Stock Exchange. Due to the existence of two dependent variables (conditional and unconditional conservatism), the research hypotheses were studied separately. Unlike the theoretical principles, the research findings showed that the systematic risk has a positive effect on conditional and unconditional conservatism and increases it. This showed that the more systematic risk will deserve more conservative approach because management has more information than the externals and their preferences are not in line with those of the beneficiaries and this is due to the agency problems. Thus, this issue results in a limitation in the distribution of assets and dividends among the investors. It should be noted here that he results of the present research do not accord with those of Garcia & et al (2010) and John Chi (2011).

Considering the research results, some suggestions are given to following groups: **1.** Investors: regarding the results of this research, it is always suggested for the users of financial statements to consider variables such as systematic risk when they analyze to purchase the firms' stocks. Also it is suggested to consider the positive effect of systematic risk on the conditional and unconditional conservatism approach of the managers in financial reporting. 2. Managers: regarding the fact that managers tend to deserve the trust of the owners, they should consider that by enhancing the conditional and unconditional conservatism approach they can prevent the overestimations of the profits by the beneficiaries.3. Stock Exchange Organization: it is suggested that the Stock Exchange Organization devise some rules and regulations to make the data transparent and perceive their performances better regarding the direct relationship between the systematic risk and the conditional and unconditional conservatism to

identify the real value of the companies and let the firms accepted to use conservatism approaches as much as possible to reduce the controversies among the managers and the investors.

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