Accounting Conservatism and Corporate Governance’s Mechanisms (Evidence from Tehran Stock Exchange)

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ABSTRACT

Accounting conservatism is one of the main characteristics of financial reporting, which has been incorporated in accounting theory and practice for a long time. Conservatism can be a tool for efficient contracts and by limiting the field for opportunistic behavior of managers, cause be protect the interests of stakeholders and increase the company’s value. The main objective of this study is investigating the relationship between corporate governance and conservatism in financial reporting of listed companies in Tehran Stock Exchange. In this study, to operationalize the conservatism coupled used Feltham and Ohlson (1995); and used by board independence, board size, debt reliance as proxy for corporate governance. To investigate this relationship used the multiple regression models. Findings of investigation of 203 companies listed in Tehran Stock Exchange in the 2006 to 2012 by unbalanced Panel model representative, relation between conservatism and corporate governance was not significant. However, there was a significant positive relationship between profitability and conservatism.

KEYWORD

corporate governance, conservatism, corporate governance’s mechanisms.

INTRODUCTION

Accounting conservatism is one of the main characteristics of financial reporting, which has been incorporated in accounting theory and practice for a long time. As traditional definition, accounting conservatism: don’t forecast any profit, but forecast all loss. Basu (1997) argues that accounting conservatism has been established for at least 500 years in Europe. An extreme form of conservatism in practice generally means that a company should “anticipate no profit, but anticipate all losses”.

Conservatism is derived from contracts with various individuals and groups. According this interpretation, accounting conservatism to consider the moral hazard created by various groups that have information asymmetric, asymmetric returns, limited horizons and limited liability are included.

Corporate Governance is set of systems, processes and structures that using intra-organizational & out-organizational mechanisms seek preserve the rights of stakeholders, accountability, clarifying and equity in the business.

Basu quoted Pennford acknowledges the historical records of the early 15th century about partnership Firms show accounting in medieval Europe was conservative. Despite of long history conservatism concepts in accounting and increases conservatism over time, however, to date, coherent and acceptable definition of conservatism has not provided so that can be accepted by everyone.

Watts (2003) knows conservatism a mechanism of efficient in contracts between company, creditors and shareholders that cause be more efficient the contracts and contractors will protecting the opportunity behavior of management. In addition conservatism can to protect auditors and company against lawsuits.

Existing literature on accounting shows that corporate governance is an important factor in increasing the efficiency of contracts. Due to the overlap conservatism and corporate governance objectives, expected there is relationship between these two important issues in accounting.

The purpose of this study was to investigate the impact of corporate governance on conservatism.

Extensive research done on conservatism in different countries, but the first research on the relationship between corporate governance and conservatism has done in 2004.

Beekes et al. (2004), examine the links between accounting quality, proxied by earnings timeliness and conservatism, and the composition of the board of directors. Results indicate that firms with a higher proportion of outside board members are more likely to recognise bad news in earnings on a timely basis. However, firms whose boards comprise a relatively high proportion of outsiders do not display greater reporting conservatism with regard to the recognition of good news. These findings suggest that board composition is an important factor in determining the quality of UK firms’ reported earnings with respect to incorporating bad news on a timely basis.

Khan, Mozaffar and Watts, Ross, L (2007), estimate a firm-year measure of accounting conservatism, examine its empirical properties as a metric, and illustrate applications by testing new hypotheses that shed further light on the nature and effects of conservatism. The results are consistent with the measure,
C. Score, capturing variation in conservatism and also predicting asymmetric earnings timeliness at horizons of up to three years ahead. Cross-sectional hypothesis tests suggest firms with longer investment cycles, higher idiosyncratic uncertainty and higher information asymmetry have higher accounting conservatism. Event studies suggest increased conservatism is a response to increases in information asymmetry and idiosyncratic uncertainty.

Thai, Kriengkrai, and Kuntisook, Kiatniyom (2009), investigate the association between the board of directors, the audit committee and the external auditor (as well as an aggregate governance index) and the extent of conservatism evident in Australian firms' financial reporting. Overall, the results provide only weak evidence that firms with certain governance characteristics report more conservatively. Evidence of any such link is restricted to measures of board composition and leadership, and even then the results are sensitive to the method used to measure the extent of conservatism in financial reporting.

LaFond, R., Watts, R. (2010), argue that information asymmetry between firm insiders and outside equity investors generates conservatism in financial statements. Conservatism reduces the manager's incentives and ability to manipulate accounting numbers and so reduces information asymmetry and the deadweight losses that information asymmetry generates. This increases firm and equity values. Their empirical tests are consistent with their proposition that information asymmetry is significantly positively related to conservatism after controlling for other demands for conservatism. Further, the tests are more consistent with their prediction that changes in information asymmetry between equity investors lead changes in conservatism than the FASB's proposition that conservatism produces information asymmetry among equity investors. An important implication is that, if the FASB was successful in meeting their stated goal of eliminating conservatism in financial reporting.

The idea underlying the use of MTB (or BTM) as a measure of accounting conservatism is that, ceteris paribus, a conservative accounting system tends to depress the net book values of a firm relative to the firm’s “true” economic value. Therefore, a higher MTB (and a lower BTM) implies a higher degree of accounting conservatism, and vice versa. The MTB measure is strongly rooted in the analytical work on the Residual Income Valuation Model (RIVM). Feltham and Ohlson first introduced accounting conservatism in the RIVM context, and characterize conservatism as a tendency to bias downwards the book value of a firm relative to its market value. This manifestation of conservatism has been carried into later analytical works on conservatism. Thus, this study was calculated to summarize the degree of conservatism:

\[
\text{CONS}_i = \frac{\text{MV}_i}{\text{BV}_i} \quad (2)
\]

In this relationship:
- \( \text{MV}_i \): The market value of equity of firm \( i \) in the end of year \( t \).
- \( \text{BV}_i \): The Book value of equity of firm \( i \) in the end of year \( t \).

**INDEPENDENT VARIABLES**

Several proxies have been used for corporate governance. In this study, three variables of board independence, board size, debt reliance as proxies of corporate governance.

- \( \text{BZ}_i \): Board members the company \( i \) at the end of \( t \) is an indication of the size of the board.
- \( \text{Indep}_i \): Percentage of non-executive members of the board of the company \( i \) in end of the year \( t \), which indicates the degree of board independence.
- \( \text{BET}_i \): Percentage of debt to total assets of the company \( i \) in the end of the year \( t \).

**CONTROL VARIABLES**

- \( \text{SIZE}_i \): Represents the size of firm \( i \) in year \( t \). Watts and Zimmerman (1986) have argued that larger firms are more likely to face political costs and are more willing to use conservatism. We expected larger firms use more conservative accounting. So in this study, firm size consider as a Control variables. To determine the firm size used from Ln of total assets.
- \( \text{ROA}_i \): Represents turnover assets firm \( i \) in year \( t \), which is used to assessment the performance of companies reviewing.

**RESULTS**

The proposed study gathered the historical information of 203 firms over the period of 2006-2012, which yields 1421 year-firm data. Next we need to figure out whether we should use fixed effect or random effect as well as pooled or panel method. This could be accomplished based on Chaw and Husman tests summarized in Table 1. The results of Table 1 indicate that we must use pooled method. In addition, we have investigated the correlation among independent variables and our survey did not indicate any strong relationship correlation among independent variables.
In this section, we present details of our investigation on testing the relationship between dependent and independent variables. Table 2 shows details of our findings. We now process the main hypothesis as well as other sub-hypothesis of the survey.

### Tab.1. The summary of the results of Chaw

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>t-value</th>
<th>Sig.</th>
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<tbody>
<tr>
<td>C</td>
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<tr>
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<td>0.9489</td>
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<tr>
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<td>1.616098</td>
<td>2.255786</td>
<td>0.0242</td>
</tr>
</tbody>
</table>

### Tab.2. The summary of regression analysis

As we can observe from the results of Table 2, the relationship between CONS and Size is not meaningful when the level of significance is five percent. Therefore, the main hypothesis of the survey is not confirmed.

As we can observe from the results of Table 2, the relationship between CONS and ROA is meaningful. Therefore, the main hypothesis of the survey is not confirmed.

### CONCLUSION

Conservatism is one of the main instruments in financial reporting that make use caution in the recognition and measurement of income and asset. Conservatism can be a tool for more efficient contracts and to limit tendency for opportunistic behavior of the managers is protected from outsider users. In addition, conservatism can be protecting of Company and even independent auditors against lawsuits. Due to the asymmetric utility functions individual; that roots is in prospect Theory; and the possibility of opportunistic behavior accession, accounting conservatism could be appropriate tool to neutralize opportunistic behavior. On the other, appropriate corporate governance also provides mechanisms for the control of opportunistic behavior and provides efficient contract. This study examined the relationship between corporate governance and conservatism. In this regard, used conservatism model Feltham and Ohlson model (1995). To investigate the relationship it used multivariate linear regression model. The Results of the survey of 203 companies listed in Tehran Stock Exchange during the period 2006 to 2012 (1421 firm-years) shown that there is no significant relationship between corporate governance and conservatism.

### REFERENCES

