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Liability and the Relationship With Accounting Conservatism Among Companies Listed at Tehran Stock Exchange

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Abstract. The resent study aims at investigating the relationship between liability and accounting conservatism, while having in mind the primary goal of management as to maximize shareholders' wealth. Financial statements of 80 companies listed at Tehran Stock Exchange from 2006 to 2011 were analyzed. The companies in order to satisfy higher return should have adequate and appropriate financial resources, which are provided by using financial instruments such as liability and stock. Population of the study accounts for 80 companies listed at Tehran Stock Exchange, among which 68 were chosen through elimination sampling method. Hypotheses of the study were tested using multivariate regression model and T-test.

Keywords: conservatism; financing; liability.

Introduction

Decisions concerning the selection of financial instruments are those made for gaining cash for investment and meeting financial needs. Companies can finance through liabilities and the equity. Financing through liability is optimal when interest expenses related to that liability are lower than the return of using cash from that liability. If a company gets a loan and faces shortage of cash upon loan maturity, it will be pushed to sell some part of its assets to pay off creditors, while it needs not to pay dividends for ordinary shareholders. A major advantage of financing from the equity is that the company is not bound to pay for ordinary shareholders. Conservatism is a feature of financial reporting, which, in a form of restrictive covenant in the framework of accounting principles and concepts plays a significant role in restricting optimistic behavior of managers, as information providers, and contributes to estimating the least return from investors and creditors, as users of information.

Statement of the problem

Conservatism is a concept of essential importance in accounting which is frequently used in providing financial information. As a restrictive covenant in accounting, conservatism is used for

many years by accountants and, despite strong criticisms, still remains applicable among other accounting principles and assumptions. Conservatism is defined in the literature in two ways. First, Feltham and Ohlson (1995) define it as a bias in undermining book value of stock to market value. This definition looks at conservatism in terms of balance sheet, from which the measure of market

value to book value $\left(\frac{M}{B}\right)$ is derived. Second, it is defined as an inclination to accelerate identification of losses and postponement of identifying gains, which indicates a loss and gain attitude, upon which Basu introduced asymmetric timeliness measure in 1997 (Price, 2005). [17]

Conservatism is an important contract in financial reporting that leads to cautious recognition and measurement of earnings and assets (Basu, 1997). Studies indicate that if a company is in need of external financing, it first releases the most reliable securities. Accordingly, companies primarily turn to debt and liability, and then try to exploit convertible bonds or common stock for financing. This study undertakes to study and explain dynamics of the relationship between financing through liability and conservatism in accounting.

Basu defines conservatism as “the accountant’s tendency to require a higher degree of verification for recognizing good news in earnings than for bad news” (1997). Since annual returns of stock include news collected during the year, this definition affects the relationship between return-earnings. Using regression model of annual returns and earnings, Basu demonstrates that earnings response to negative returns (bad news) is greater and timelier than that for positive returns (good news). Basu called this different response of returns to good and bad news as asymmetry timeliness measure for conservatism (Roychowdhury & Watts, 2007). [18] In other words, asymmetry timeliness measure indicates that earnings’ responses to negative return are faster and greater than good news (positive returns). Therefore, using Basu’s measure it can be said the more asymmetry timeliness of earnings, the higher conservatism in financial reports. Companies in their competitions need external financing which serves as a facility for financing in the development of present banking system. However, only a minor part of financial resources are absorbed in the bank network. So a great effort should be dedicated to absorbing different financial resources and allocation of them to desirable tasks. Capital market is a place for financing long-term funds. Investors are primarily interested in increasing their wealth with the aim of investing in different companies, which is done through gaining returns (Jahankhani & Moradi, 1996). Companies use external and internal financing to expand and broaden their activities or to compensate for shortage of cash. Internal resources include cash flow from operation, cash from selling assets, and external resources include getting loans from financial markets and issuance of stock (Rahimian, 2002). [3]

Four factors determine conservatism in financial reporting:

1. Arbitrary interpretation of conservatism
2. Judicial interpretation of conservatism
3. Legislative interpretation of conservatism
4. Tax interpretation of conservatism

The leading demand for conservative accounting arises from the role of accounting contracts (Watts, 2003). Stock and bonds issuance are used as financing instruments.

Significance of the study

Companies use long- and short-term financing and stock issuance for financing, each with its own advantages and disadvantages. If a company relies on higher levels of liability and causes a higher ratio of liability to rights of the equity, potentially it should gain more earnings than the time it didn’t use external financing. If using this method raises company’s earnings, shareholders will have higher amount of earnings with the same investment.

Based on preference theory, which emphasizes on financing performance of companies, it is suggested that companies prefer internal financing to external financing, and in the case stock issuance, they prefer debt securities to stock. This theory tells that the reason most of profitable companies use lower levels of liability is the fact that they provide their needs through internal resources. Therefore, they don’t need external cash. On the other hand, companies with lower profitability level need debt securities in order to finance their activities because their internal resources are inadequate and make them rely on liability to meet their needs.

Objectives

Scientific objectives

This study aims at reaching the following objectives:

1. Determining level of conservatism according to their financing policies through liability
2. Deterring the relationship between level and type of financing through liability with conservatism in companies
3. Determining conservatism before financing with some changes in financing through liability
4. Determining conservatism after financing with some changes in financing through liability

Practical objective

The present study is performed to realize the following objectives:

1. Considering the high level and value of cement companies listed at Stock Exchange, and high level and value of medical companies at Tehran Stock exchange, it makes investors and shareholders pay due attention to effects of liability in these companies.
2. It makes Ministry of Economic Affairs and Finance pay due attention to effects of liability in tax savings in companies.
3. It helps banks in atoning credits to companies listed Tehran Stock Exchange (in particular cement and medical companies).
4. It introduces measures used for evaluating level of conservatism to be employed in Stock Exchange and the affiliated companies.

Review of literature

Ahmad et al. (2002) studied mutual relationship between conservatism and found that increase in conservatism employed in financial statements leads to decrease in financing expenses. [9]

Gul et al. (2002) studied the relationship between conservatism and auditing wages in Hong Kong. They stated that one of the results of decreasing conservative accounting is increase in auditing activities and wages. The authors showed a relationship between significant differences in conservatism during the period of economic stagnation (1996-1997) and economic prosperity (1994-1995) and auditing wages, using some sample companies listed at Hong Kong Stock Exchange. Observing companies listed at Hong Kong Stock Exchange for seven years, they demonstrated a reverse relationship between conservative accounting in each year and average auditing wages. [13]

In a study in 2003, Huijgen & Lubberink compared level of conservatism in earnings of companies listed at U.S Stock Exchange with earnings of English companies not listed at U.S Stock Exchange. They expected earnings English companies at U.S Stock Exchange to be more conservative than other companies. Two reasons are proposed for this.

1. These companies have lower shareholder legal claims in England.
2. Shareholders in U.S stock Exchange use high quality financial reports.

Study period covers the years between 1993 and 2002. They found that earnings of English companies listed at U.S Stock Exchange were more conservative than other English companies. Therefore, their findings in a way confirmed determining legal claims against conservatism.

Beekes (2004), confirming Ahmad and Duel-Man, claims that the presence of higher number of board of directors' out-of-duty members causes an increase in conservatism. [11]

Lara et al. (2005), "Accounting Conservatism and Corporate Governance", in a span of years between 1992 and 2003 and among American companies, used a synthetic measure for evaluating corporate governance and Basu measure in order to investigate conservatism. Their result showed a significant and positive relationship between the two. [16]

Ahmad and Duel-Man (2005), "The Role of Conservatism in Accounting on Corporate Governance", performed a study on 750 American companies from 19910 to 2001, using three types of measures to evaluate conservatism:

- a. Givoly and Hayn's accumulated accruals measure (2000)
- b. Beaver & Ryan's ratio of market value to book value (2000)
- c. Asymmetry timeliness measure to earnings (1997)

The authors showed that:

1. There is a negative relationship between conservatism and share value of internal managers (chosen from among major shareholders and company owners).
2. There is a positive relationship between share value of external managers and conservatism.
3. There is no significant relationship between number of board of directors and conservatism.
4. There is no significant relationship between investment ownership and conservatism. [10]

Mashmoul-Bonab (2005) conducted a research on current food industry in the years 1996 to 2001 to compare effects of financing through loan on earnings. Results showed an insignificant relationship between financing through loan and earnings of companies in food industry. This insignificance is justified based on the amount of using loan by food industries. Investigating companies in car industry, with 59% using loan for financing, confirmed the existence of a significant relationship between loan and earnings.

Bani-Mahd & Baghbani (2006) studied effects of accounting conservatism, state ownership, firm size and ratio of leverage on losses of 48 injured companies removed from the list of Tehran Stock Exchange from the years 1380 to 1386. Results showed that accounting conservatism has a direct relationship with company losses, which is theoretically accepted and are in agreement with results of studies conducted abroad. The study also emphasized on the existence of direct relationship between firm size and company losses, on the one hand, and a reverse relationship between ratio of leverage and company losses, on the other. Results of the study indicated that state ownership had no effect on company losses, and revealed that accounting conservatism can be an effective mechanism for limiting biased behavior of managers in exaggerating earnings of injured companies. So, they considered accounting conservatism as a factor improving injured corporate value in the long run. [2]

Shahriyari (2008), "Evaluating the Relationship between Political Costs and Conservatism in Companies Listed at Tehran Stock Exchange", used information for the years between 2002-2006 to investigate the relationship between conservatism with size, degree of concentration, systematic risk, investment intensity, effective tax rate, and centralized ownership and state ownership. Givoly and Hayn model was used to evaluate conservatism and it was concluded that there is a negative relationship between centralized ownership and conservatism, while there is positive relationship between state ownership and conservatism. [6]

Rezazadeh & Azad (2008), "Relationship between Information Asymmetry and Conservatism in Financial Reporting", studied on information related to a population of companies listed at Tehran Stock Exchange during the years between 2002 and 2006. Results of their study showed a positive significant relationship between information asymmetry among investors and level of conservatism employed in financial statements. Results also indicate that following the increase in information asymmetry among investors, demand for and application of conservatism in financial reporting increases. Thus, advantages of conservatism as a quality characteristic of financial statements are confirmed. [4]

Hypotheses

1. There is a relationship between conservatism and financing policies through liability.
2. There is a relationship between conservatism with level and type of financing through liability.

Subsidiary hypotheses

1. Conservatism in companies with greater change in financing is different from those with smaller change.
2. Conservatism in companies which have higher financing through stock issuance is different from companies with financing through liability.
3. There is a relationship between conservatism before and after financing with financing change through liability.

Methodology

Scientific studies are classified into three groups as regards their goals: fundamental, applied, research and development. Since the present study undertakes to study the relationship between financing through liability and accounting conservatism, and can be beneficial to large group of

people including shareholders, researchers, and Stock managers, it can be considered an applied work in this field, which utilizes regression method.

Givoly and Hayn model

Following Basu (1997), Givoly and Hayn (2000) investigated evolution of conservatism to answer the question that whether financial reporting has become more conservative or not. Relying on a particular definition, they used non-operating accruals to measure conservatism. Based on this definition, conservatism is used in identifying a reporting financial event when managers are first and foremost faced with ambiguity and lack of certainty and are pushed to choose from among one or more options, and secondly, have to choose a method that results in the least possible amount of accumulated earnings. Givoly and Hayn used accruals and non-operating accruals because accrual accounting is a channel for applying conservatism, on the one hand, and applying managerial authority in the lack of certainty, on the other, paved the way for the emergence of conservatism. The sum of accruals and non-operating accruals is calculated as below:

$$\begin{aligned} \text{ACC}_{i,t} &= (\text{NI}_{i,t} + \text{DEP}_{i,t}) - \text{CFO}_{i,t} \\ \text{OACC}_{i,t} &= \Delta(\text{AR}_{i,t} + \text{I}_{i,t} + \text{PE}_{i,t}) - \Delta(\text{AP}_{i,t} + \text{TP}_{i,t}) \\ \text{NOACC}_{i,t} &= \text{ACC}_{i,t} - \text{OACC}_{i,t} \end{aligned}$$

Where

ACC is accumulated accruals, NI is net income before unexpected items, DEP is depreciation cost, CFO is cash flow from operation, OACC is operating accruals, AR is accounts receivable, I is inventory of goods and materials, PE is prepayment, AP is accounts payable, TP is tax payable and NOACC is non-operating accruals. Non-operating accruals include amounts which are affected by management estimates and judgments. For instance, doubtful receivables increase in costs due to changing estimates, loss and gain of selling assets, loss caused by decreased value of inventory and fixed assets and transitional items to future periods. Givoly and Hayn calculated accruals as follows (Bani Mahd 1385, p. 720)

$$\text{Conservatism index} = \frac{\text{operating accruals before depreciation}}{\text{total assets at the beginning}} \times (-1)$$

In other words, operating accruals means working capital change without considering cash change.

Non-operating accruals = working capital change – cash change

Sum of accruals before depreciation = (depreciation + net earnings) – cash flows yielded from operation

It should be considered that depreciation is a part of accruals, usually of long-term accruals. But Givoly and Hayn did not take depreciation into account in their study.

Non-operating accruals = sum of accruals before depreciation - operating accruals

Non-operating accruals are considered to be deposits for doubtful receivables, deposits stemming from losses caused by decreased assets value, inventory of goods and reconstructing costs. Conservatism index according to Givoly and Hayn model equals to) Bani-Mahd, 2006: p.73):

$$\text{Conservatism index} = \text{cash flow from operation} - \frac{\text{depreciation} + \text{earnings before unexpected items}}{\text{total assets at the beginning}}$$

The above index is used for measuring conservatism in the present study. [12]

Model of financing instruments through liability

Financing change through liability is one of the variables of the study which is measured using level of change in liability and level of change in stock. Balance sheet and cash transactions statement approaches are proposed for measuring these two variables. In balance sheet approach, change in financing through liability is calculated by the following model:

$$\Delta XFIN_{BS} = \Delta EQUITY_{BS} + \Delta DEBT_{BS}$$

$\Delta XFIN_{BS}$ = net change in financing

$\Delta DEBT_{BS}$ = level of change in rights of shareholders

ΔDET_{BS} = level of change in liability

Level of change in the rights of shareholders equals to level of change in ordinary stock from the year t-1 to t, which is calculated as:

$$\Delta EQUITY_{BS} = \frac{\Delta CEQUITY_{BS}}{PARVALUE}$$

$$\Delta CEQUITY_{BS} = CEQUITY_t - CEQUITY_{t-1}$$

CEQUITY_t = book value of the ordinary stock at the year t.

CEQUITY_{t-1} = book valued of ordinary stock at the year t-1.

PARVALUE = nominal value per share

Level of change in liability equals to level of change in short-term liability plus level of change in long-term liability, which is calculated as:

$$\Delta DEBT_{BS} = \Delta LTDEBT_{BS} + \Delta SHTDEBT_{BS}$$

$\Delta LTDEBT_{BS}$ = level of changes in long-term liability between the years t-1 and t, which is calculated by the following equation:

$$\Delta LTDEBT_{BS} = \Delta LTDEBT_t - LTDEBT_{t-1}$$

$\Delta SHTDEBT_{BS}$ = level of changes in long-term liability between the years t-1 and t, which is calculated by the above equation.

Population of the study covers all the companies listed at Tehran Stock Exchange, satisfying the following features:

1. All sample companies listed at Stock Exchange till 1383/12/29.
 2. Their fiscal year end in Esfand.
 3. They haven't changed their fiscal year during the research period.
 4. They are listed as investing, holding, and financial mediating companies.
 5. Their explanatory notes should be available.
 6. At least, they have financed through either stock issuance or receiving liability.
- Considering the above criteria, only 80 companies were sampled.

Results of testing hypotheses

The first hypothesis claims that conservatism has a direct relationship with financing through liability policies. To test the first hypothesis, the following model has been used:

$$CON_{i,t} = \alpha + \beta_1(Ltf_{i,t}) + \beta_2(Shtf_{i,t}) + \beta_3(Size_{i,t}) + \beta_4(Lev_{i,t}) + \varepsilon_{i,t}$$

able 5.4. Results of testing hypothesis 1

variable	symbol	Coefficient (B)	t statistics	P-Value
Fixed value	α	0/079	0/539	0/590
Long-term financing	Ltf	1/221	3/003	0/003
Short-term financing	Shtf	1/176	1/061	0/290
Firm size	Size	-0/014	-1/176	0/241
leverage	Lev	0/015	0/853	0/394
Regression model	F statistics	P-Value	Durbin-Watson statistics)D-W(Adjusted Coefficient of determination
	6/040	0/000	2/018	0/077 R ² = 0/064= AdjR ²

Results of testing hypothesis 1 (Table 5.4) show a significant F statistics (0.000) which is lower than 5%. Accordingly, regression model is significant. Durbin-Watson statistics (2.018) lies between 1.5 and 2.5; therefore, there is no correlation between different parts of model error. Regarding high level of P-Value of t-statistics which is higher than acceptable error level, results show a positive and significant relationship between conservatism and long-term financing. On the other hand, considering high significance of t-statistics, results demonstrate no relationship between conservatism and short-term financing. Also, results reveal that there is no relationship between conservatism and control variables such as firm size and leverage. Coefficient of determination and adjusted coefficient of determination show that regression variables can explain only 7.7% of changes in dependent variable.

Results of testing hypothesis 2

Hypothesis 2 states that level and type financing through liability has a relationship with level of conservatism.

Level:

a. First subsidiary hypothesis is derived from second main hypothesis

Conservatism in companies with bigger financing changes is different from those with smaller financing changes. To test the first subsidiary hypothesis, companies were first classified into the two control and sample groups, taking the level into account:

Companies in which financing changes to total assets during the year T was bigger than 7% (sample companies).

Companies in which financing changes to total assets during the year T was smaller than 7% (sample companies).

Then, using t-test for the two independent populations (Table 6.4) the above hypothesis is tested:

Table 6.4: Testing subsidiary hypothesis 1 derived from second hypothesis

mean		variance Lopen test		Mean t-test	
big financing changes	Small financing changes	F-statistics	Significance level (P-Value)	t-statistics	Significance level (P-Value)
-0/066	-0/073	4/393	0/037	0/397	0/692

The value of F-statistics is 4.393 and its significance level is 0.037, which is lower than acceptable error level. Thus, the assumption of equality of variances is rejected. Therefore, independent t-test with adjusted degree of freedom has been used. T-statistics is 0.397 and significance level is 0.692, showing that there is no significant difference between the two groups. Results show that average of companies with more financing changes is lower than companies with smaller changes.

b. Second subsidiary derived from second main hypothesis

Conservatism in companies, which has more financing through stock issuance, is different from those financing from liability. To test the second subsidiary hypothesis, companies were first classified into the two control and sample groups, taking the level into account:

Companies in which financing changes through stock issuance is greater financing changes through liability ($\Delta EQUITY > \Delta DEBT$) (sample companies).

Companies in which financing changes through stock issuance is smaller financing changes through liability ($\Delta EQUITY < \Delta DEBT$) (sample companies).

Then, using t-test for the two independent populations (Table 7.4) the above hypothesis is tested:

Table 7.4: Testing subsidiary hypothesis 2 derived from second hypothesis

mean		variance Lopen test		Mean t-test	
big financing changes	Small financing changes	F-statistics	Significance level (P-Value)	t-statistics	Significance level (P-Value)
-0/080	-0/054	3/694	0/045	-0/661	0/048

The value of F-statistics is 3.694 and its significance level is 0.045, which is lower than acceptable error level. Thus, the assumption of equality of variances is rejected. Therefore, independent t-test with adjusted degree of freedom has been used. T-statistics is -0.661 and significance level is 0.048, showing that there is a significant difference between averages of the two groups. Results show that accounting conservatism in control group companies is more than sample group. That is companies which their financing changes through stock issuance are lower than changes through liability.

Results of testing hypothesis 3

The third hypothesis states that conservatism before financing has a relationship with changes in financing through liability. The following model is used for testing the third hypothesis:

$$CON_{before} = \alpha + \beta_1(\Delta Xfin_{i,t}) + \beta_2(Size_{i,t}) + \beta_3(Lev_{i,t}) + \varepsilon_{i,t}$$

Results are given in Table 8.4.

Table 8.4: Results of testing the third hypothesis

variable	symbol	Coefficient (B)	t statistics	P-Value
Fixed value	α	0/075	0/563	0/574
Changes in financing through liability	($\Delta xfin$)	9/247	2/808	0/005
Firm size	Size	-0/014	-1/286	0/199
leverage	Lev	0/018	0/917	0/360
Regression model	F statistics	P-Value	Durbin- Watson statistics)D-W(Adjusted Coefficient of determination
	5/108	0/002	1/799	0/048 R ² = 0/039= AdjR ²

Results of testing hypothesis 3 (Table 8.4) show a significant F statistics (0.002) which is lower than 5%. Accordingly, regression model is significant. Durbin-Watson statistics (1.799) lies between 1.5 and 2.5; therefore, there is no correlation between different parts of model error. Regarding low level of P-Value of t-statistics which is lower than acceptable error level, results show a positive and significant relationship between conservatism before financing and changes in financing through liability. Also, results reveal that there is no relationship between conservatism and control variables such as firm size and leverage. Coefficient of determination and adjusted coefficient of determination show that regression variables can explain only 5% of changes in dependent variable.

Results of testing hypothesis 4

The fourth hypothesis claims that conservatism after financing has a relationship with changes in financing through liability. The following model is used for testing the fourth hypothesis.

$$CON_{after} = \alpha + \beta_1(\Delta Xfin_{i,t}) + \beta_2(Size_{i,t}) + \beta_3(Lev_{i,t}) + \varepsilon_{i,t}$$

Results are given in Table 9.4.

Table 9.4: Results of testing the third hypothesis

variable	symbol	Coefficient (B)	t statistics	P-Value
Fixed value	α	-0/141	-0/874	0/383
Changes in financing through liability	($\Delta xfin$)	6/429	1/566	0/119
Firm size	Size	0/003	0/238	0/812
leverage	Lev	0/038	1/761	0/080
Regression model	F statistics	P-Value	Durbin-Watson statistics)D-W(Adjusted Coefficient of determination
	4/424	0/005	1/993	0/050 $R^2 =$ 0/039= Adj R^2

Results of testing hypothesis 4 (Table 9.4) show a significant F statistics (0.005) which is lower than 5%. Accordingly, regression model is significant. Durbin-Watson statistics (1.993) lies between 1.5 and 2.5; therefore, there is no correlation between different parts of model error. Regarding high level of P-Value of t-statistics which is higher than acceptable error level, results show that there is no significant relationship between conservatism after financing and changes in financing through liability. Also, results reveal that there is no relationship between conservatism and control variables such as firm size and leverage. Coefficient of determination and adjusted coefficient of determination show that regression variables can explain only 5% of changes in dependent variable.

NO	Description		Results	
			Confirmed	Rejected
1	Conservatism has a relationship with policies of financing through liability		*	
2	level	Conservatism in companies with bigger changes in financing is different from those with smaller changes in financing		*
	type	Conservatism in companies with bigger changes in financing through stock issuance is different from those with bigger changes in financing through liability	*	
3	Conservatism before financing has a relationship with changes in financing through liability		*	
4	Conservatism after financing has a relationship with changes in financing through liability			*

Results and recommendations

This study investigated financing through liability with conservatism using multivariate regression. It used financial information of 80 companies for a period of 6 years from 2006 to 2011. Four hypotheses were proposed: First, conservatism has a relationship with policies of financing through liability which was tested by the model proposed by Givoly and Hayn. Results confirmed this relationship. Second hypothesis investigated the relationship between conservatism with level and type of financing through liability which ends in rejecting this relationship. The third hypothesis examines the relationship between conservatism before financing and changes in financing through liability that confirms the existence of such relationship. The fourth hypothesis examines the relationship between conservatism after financing and changes in financing through liability and rejects the existence of this relationship.

1. Investigating the relationship between conservatism and earnings management
2. Investigating the relationship between financing through liability and earnings management
3. Investigating the relationship between conservatism and costs of agency

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