

A Study of the Role of Accounting Conservatism in Managers' Investment Decision of the Accepted Firms in Tehran Stock Exchange

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ABSTRACT

This study is conducted to examine the role of accounting conservatism in managers' investment decision of the accepted firms in Tehran Stock Exchange. In order to measure conservatism, two criteria called future profitability and specific items have been applied. The variables include conservatism, ROE average, CFO average, PM average, ROE standard deviation, PM standard deviation, leverage, size, total expenditures of research, development and advertisement, Past and specific items. Also, 60 accepted firms in Tehran Stock Exchange between years of 2003 to 2009 were reviewed by the use of ordinary least squares regression (OLS) method in order to test the research hypotheses. The results demonstrate that the level of conservatism in the accepted firms in Tehran Stock Exchange does not affect future operating cash, yet has an impact on firm profit margin; therefore, it can be concluded that the firms with a higher level of conservatism gain more profit margin in comparison with those with a lower level of conservatism and managers can depend on these levels to make decisions on investment. Moreover, the level of conservatism does not lead to the less identification of specific items as cost; in other words, the level of conservatism does not affect the identification of specific items.

KEYWORDS: Accounting conservatism – levels of conservatism in accounting – managers decision making on investment – future profitability – specific items

INTRODUCTION

Previous studies suggest that conservatism potentially reduces the problems of representatives related to the managers' investment decision. In particular, Ball and Shivakumar (2005) argue that if managers recognize planning:

1. There is less possibility to invest with negative net present value (NVP).
2. There is more possibility to take immediate action in order to prevent economic losses as a result of poor investments (Ball & Shivakumar, 2005).

Our evidences concerning the benefits of conservatism in controlling managers' investment decision provides an extra insight over pure benefit conservatism which is questioned and criticized by standard setters. For instance, the FASB (2008, p. 28) is most probably affected by the financial situation report and performance in providing an exposure draft framework on conservatism financial report. This conceptual framework does not include prudence or conservatism as a desirable quality for financial report. Watts (2003, p. 208) states that regarding the long-term existence of conservatism and its obvious flexibility toward, critics ignore considerable benefits of conservatism. If regulator and standard setter critics make an effort to eliminate conservatism without comprehending its benefits, the results of the standards will severely lead to losses (Watts, 2003).

The conservatism convention is so pervasive that no standard board can ignore it. Even the Financial Accounting Standard Board which does not involve it in the qualitative features of accounting information believe that conservatism is inevitable in accounting practice (Mojtahedzadeh, 2001).

Conservatism is a crucial attribute of an accounting system that can contribute to decision makers in reducing high volume operations as well as arranging other sources of information via increasing stockholders and firm equity value (Watts, 2006).

In this research, we plan to examine the role of accounting conservatism in managers' investment decision in Tehran Stock Exchange. There is also an attempt to answer the following questions:

1. Do the firms with more accounting conservatism have more future profitability in comparison with those with lower accounting conservatism?
2. Do the firms with more accounting conservatism identify less specific items in comparison with those with less accounting conservatism?

Now in this study, we determine how the levels of conservatism are selected and why managers do not deviate from the real conservatism?

LITERATURE REVIEW

Beekes and others (2004) reviewed profits as conservatism as well as board composition for quality criteria of accounting in a study entitled "the conservatism and profit timeliness". By applying a number of samples from England and time asymmetry of benefit model introduced by Basu (1997), they came to the conclusion that companies which are more independent in case of board members are more conservative; Therefore, the results demonstrated that the situation of the board members is an prominent factor in determining the quality of reported earnings in English firms. (Beekes,2004)

Ahmad and Duellman (2007) reviewed the relationship between conservatism and corporate governance mechanisms and methods. They made use of firm size, liabilities and growth opportunities as control variables. Applying three criteria including time asymmetry conservatism, accruals and market values, indicated that:

- a. There is significant and positive relationship between firm size and conservatism concerning accruals criteria.
- b. There is significant and negative relationship between firm size and conservatism concerning market value criteria.
- c. There is no significant relationship between firm size and conservatism concerning time asymmetry criteria.

Moreover, the following conclusions were obtained:

There is significant and positive relationship between conservatism and liability ratio concerning accrual criteria.

There is no significant relationship between conservatism and liability ratio concerning market value criteria.

There is no significant relationship between conservatism and liability ratio concerning time asymmetry criteria (Ahmed & Duellman,2007).

Lafond and Roychowdhury (2008), investigated the relationship between conservatism and the percentage of managers ownership within a study.

They took Basu Model as a criterion for conservatism and firm size, liabilities as well as law risk claims as control variables. According to his findings, there is significant and positive relationship between conservatism and liability ratio; it means that demanding for conservatism is increased along with liability level. Also, there is a significant and negative relationship between firm size and conservatism (LaFond, Roychowdhury,2008).

Lim (2009) applied three models in order to assess accounting conservatism in a research entitled " A Study of the Relationship between Accounting Conservatism and Firm dominance". Among Australian firms, he came to the conclusion that there was a positive relationship between independent managers on the staff and accounting conservatism in one of the three models between 1998 and 2002(Lim,2009).

Thai & Kuntisook (2009) concluded the followings between,(2000 to 2006) in 331 firms in a study entitled "Accounting Conservatism and Shareholders Controlling Traits":

1. Firms have more conservatism along with independence of managers on staff and more ownership concentration (the percentage of the first principle shareholder).
2. Firms have less conservatism along with enormous size and high leverage.

There is no relationship between the ownership of agency shareholders and conservatism (Thai & Kuntisook, 2009).

Sunder and Zhang (2009) studied the effect of conservatism on liability contracts. The results demonstrate that there is a direct relationship between conservatism and the level of liability (Sunder & Zhang 2009).

Mehrani, Moradi and Eskandar (2010) studied the relationship of agency ownership and conservative accounting. The results indicate a positive relationship between agency ownership and profit conservatism. In other words, firms tendency toward using conservative method in increased along with the level of agency ownership (Mehrani, Moradi, Eskandar,2010).

Mashayekh,Mohammadabadi and Hesarzadeh (2009) reviewed the effect of accounting conservatism on profit stability. They concluded that share profit distribution in decreased along with the increase of accounting conservatism of the accepted firms in Tehran Stock Exchange. Also, based on the obtained results, the researcher makes no mention of accepting or rejecting the hypothesis that the stability of profit in decreased along with the increase of accounting conservatism level simultaneously (Mashayekh, MohammadAbadi, Hesarzadeh, 2009).

Jafari and Garkaz (2008) conducted a study on the relationship between conservatism and future profits as well as operational cash flows. This study aimed at seeking a relationship between the degree of conservatism applied in providing financial statements and future profits as well as operational cash flows.

In order to obtain the above goal, 6 hypotheses were examined:

1. There is a significant relationship between the conservatism of the current year and the operational profit of one year later.

2. There is a significant relationship between the conservatism of the current year and the operational profit of two years later.
3. There is a significant relationship between the conservatism of the current year and the operational profit of three years later.
4. There is a significant relationship between the conservatism of the current year and the operational cash flows one year later.
5. There is a significant relationship between the conservatism of the current year and the operational cash flows two years later.
6. There is a significant relationship between the conservatism of the current year and the operational cash flows three years later.

The population of this research was the accepted firms in Tehran Exchange Stock and were reviewed between 1379 to 2006 (a period of seven years).

The results of the present study demonstrated that there is a significant relationship between the conservatism of the current year and the operational profit of one year later. In the other hypotheses, there are no significant relationships (Jafari & Garkaz 2008).

BaniMahd (2006) studied the relationship between accounting conservatism and a number of alliance sheet variables, profit and loss variables and the variables related to the circulation of cash flows. Having proved the relationship between a number of these variables by the use of the variables including correlational relationship with accounting conservatism, he presented a conceptual model to measure accounting conservatism (Banimahd, 2006).

Research Hypotheses

According to the studies which have been carried out and the theories, the research hypotheses are defined as follows:

H1: The level of conservatism has a significant effect on future profitability of firms.

H2: The level of conservatism has a significant effect on less identification cost of future specific items.

RESEARCH METHODOLOGY

This study is pragmatic from the aspect of goal and performance, and descriptive-gauging from the aspect of data collection, information and examining the research hypotheses. The research design is back event correlation, the distribution of sample is normal and the statistical method is parametric .The aim of correlation research is to study the limits of changes in one or some variables with the limits of one or some other variables. This study is applied in the relationship between the variables that have been gained from one category or a group of information obtained from two or some groups. Each of the hypotheses has been examined by the use of true information based on true performance of Tehran Stock Exchange during conducting the research.

In this study, in order to do a statistical analysis, the descriptive statistics including mean, median, and standard deviation were used; in addition, to examine normalization of the population, Kolmogorov Smirnov was applied. On the other hand, to examine the hypotheses, deductive statistics tests such as correlation coefficient, correlation matrix, coefficient of determination(R^2), adjusted coefficient determination(\bar{R}^2), regression of at least ordinary squares (OLS), and the amount of P, if P value is < %5, then the hypothesis is accepted, otherwise it is rejected. In order to design the statistical tables, analyze statistical data, modeling, and graph drawing, SPSS and Excel soft wares were applied.

Conceptual Model and Variables

The conceptual model which is used in this study is aimed at doing the followings:

- a. To determine the impact of conservatism on the capability of future profitability, the regression model is applied.
- b. To test the impact of conservatism on specific items, the regression model is used:

$$\text{Profitability}_{i,t+2} = \beta_0 + \beta_1 \text{Conservatism}_{i,t} + \beta_2 \text{Avg. Profitability}_{i,t} + \beta_3 \text{Std. Dev. Profitability}_{i,t} + \beta_4 \text{Leverage}_{i,t} + \beta_5 \text{Growth}_{i,t} + \beta_6 \text{Size}_{i,t} + \beta_7 \text{Past}_{i,t} + \varepsilon \quad (1)$$

Where *Profitability* $i,t+2$ is either *PM* or *CFO*, *PM* $i,t+2$ is one minus the total cost of sold goods divided by pure sale, *CFO* $i,t+2$ is cash flows produced by the division of pure sale as follows:

$$PM_{i,t+2} = \frac{\text{Cost of goods sold}}{\text{total revenues}} \quad (\text{a})$$

$$CFO_{i,t+2} = \frac{\text{cash flows from operations}}{\text{total revenues}} \quad (\text{b})$$

Conservatism i,t equals the office value of the firm divided by its market value multiplied by -1 which is as follows:
Conservatism = $-1 * \text{the office value of the firm} / \text{the market value of the firm}$.

Avg. Profitability i,t equals the average profitability of the firm measure from year t to $t-2$.

Std. Dev. Profitability i,t is the standard deviation of the profitability measure over year t to $t-2$.

Leverage i,t is the total long-term liabilities divided by pure sales.

Growth i,t is the percentage of changes in pure profit in comparison with the past year.

Size i,t is the natural log of the office value of firm assets.

Past i,t is the one in case the firm takes special item charge greater than 1% of the pure profit during the time period t through $t-2$, zero otherwise.

$$\text{Future}_{i,t} = \beta_0 + \beta_1 \text{Conservatism}_{i,t} + \beta_2 \text{Past}_{i,t} + \beta_3 \text{Avg. ROE}_{i,t} + \beta_4 \text{Std. Dev. ROE}_{i,t} + \beta_5 \text{Leverage}_{i,t} + \beta_6 \text{Growth}_{i,t} + \beta_7 \text{Size}_{i,t} + \varepsilon \quad (2)$$

Where *Future* i,t is equal one if the firm takes special item charge during the period $t+1$, zero otherwise.

Avg. ROE i,t is the income from adding special items divided by the fiscal year end market value of equity and averaged over year t to $t-2$.

Std. Dev. ROE i,t is the standard deviation of ROE over the period t to $t-2$.

Return i,t is the purchase and holding market return for fiscal year t which begins four months after the fiscal year ends (Ahmed & Duellman, 2010).

Descriptive Statistics of the Research

Table 1-1 shows the variables including the number of samples, average, minimum, maximum and standard deviation. The sample data includes 300 years of the firms.

Table 1-1: Descriptive Statistics of Research Variables

	Std. Dev.	Avg.	Max.	Min.	Sample size
Conservatism	0/48	-0/539	-0/026	-4/079	300
Avg. ROE	0/127	0/226	0/763	-0/017	300
Avg. CFO	0/168	0/215	0/849	-0/16	300
Avg. PM	0/256	0/288	0/823	-2/289	300
Std. Dev. ROE	0/102	0/088	0/671	0/003	300
Std. Dev. PM	0/354	0/078	4/345	0/003	300
Leverage	0/515	0/153	5/671	0	300
Growth	1/027	0/038	6/884	-0/978	300
size	1/444	13/190	18/064	10/439	300
R&D & advertising	0/057	0/008	0/98	0	300
Past	0/225	0/053	1	0	300
Special items	0/097	0/015	1/084	-0/235	300

Table 1-2: Normal Coefficients and Standard Variables of the First Model

Model 1		Past	R&D & advertising	size	growth	Leverage	Std. Dev. PM	Avg. PM	Conservatism	Fixed value	
The ordinary least squares with CFO _{t+2}	Non-standard coefficients	β Coif.	0/037	0/066	0/001	0/002	-0/003	-	0/967	0/008	-0/003
		St. e	0/031	0/12	0/005	0/007	0/014	-	0/044	0/016	0/064
	standard coefficients	β Coif.	0/041	0/019	0/008	0/008	-0/007	-	0/806	0/018	
		T statistic	1/217	0/546	0/241	0/224	-0/2	-	22/203	0/467	-0/049
		Meaningful level	0/225	0/585	0/809	0/823	0/841	-	0/000	0/641	0/961
The ordinary least squares with PM _{t+2}	Non-standard coefficients	β Coif.	-0/013	-0/057	-0/003	0/026	0/039	-0/381	0/848	0/121	0/138
		St. e	0/081	0/317	0/013	0/018	0/038	0/092	0/134	0/045	0/176
	standard coefficients	β Coif.	-0/006	-0/007	-0/008	0/058	0/043	-0/289	0/465	0/125	
		T statistic	-0/165	-0/18	-0/203	1/428	1/04	-4/13	6/326	2/67	0/784
		Meaningful level	0/869	0/857	0/839	0/154	0/299	0/000	0/000	0/008	0/434

Table 1-3: Normal Coefficients and Standard Variables of the Second Model

Model 2	Non-st. coefficients		St. coefficients		T statistic	Meaningful level
	β Coif.	St. e	β Coif.	St. e		
Fixed value	-0/074	0/133			-0/556	0/578
Conservatism	0/027	0/039	0/048		0/707	0/48
Past	0/496	0/063	0/411		7/854	0/000
Avg. ROE	-0/302	0/172	-0/141		-1/753	0/081
St. dev. ROE	0/144	0/183	0/054		0/786	0/432
leverage	0/031	0/033	0/06		0/948	0/344
growth	0/026	0/014	0/098		1/821	0/07
size	0/014	0/01	0/074		1/334	0/183

Multi- variable Regression Analysis

Multi- variable Regression Analysis for Future Profit Making Model

Summary Model The :Table 1-4

Regression Method	R	R ²	The Adjusted R ²	Standard Deviation
The Least Ordinary Squares with CFO _{t+2}	0/816	0/666	0/658	0/113
The Least Ordinary Squares with PM _{t+2}	0/753	0/567	0/556	0/311

As it is shown in the table above, the multi-variable coefficient correlation (R) is taken into account for the model in which the operational cash, dependent and independent variables of conservatism, the average of profit earning, leverage, growth, size and Past equal 0/816. Its square (R²) or the determination coefficient for the dependent variable equals 0/666. Therefore, the model is not able to explain about 33% of conservatism changes. The adjusted R² equals 0/658 and standard deviation in evaluating the model is 0/113. Also, the multi-variable correlation coefficient (R) for the considered model in which the profit margin of dependent and independent variables of conservatism, the average of profit earning, standard deviation of profit earning, leverage, growth, size and Past equal 0/753. Its square or the determination coefficient for the dependent variable equals 0/567. Thus, it can be mentioned that 56/7 % of the changes in profit margin is explained by the independent variables. The model is

not able to explain about 43% of the conservatism changes. The adjusted R2 equals 0/556 and standard error of model evaluation is about 0/311.

Table 1-5 significant test of multi-dimensional regression

Method		Total Square	Degree of Freedom	Square Average	F	Level of Significance
The Least Ordinary Square with CFO_{t+2}	Regression	8/138	7	1/163	83/008	0/000
	Remained	8/138	292	0/014		
	Total	12/227	299			
The Least Ordinary Square with PM_{t+2}	Regression	36/489	8	4/606	47/717	0/000
	Remained	28/09	291	0/097		
	Total	64/939	299			

According to the table above, there is a significant test of R2. With regards to the fact that F is in the accepted distance (error less than 5) in both methods, so R2 is significant. It can be mentioned with 95% degree of certainty that 66% of the operational cash changes is explained by the presented model.

In accordance with the coefficients table 4-1, the common regression equation and standard can be written for the considered model based on the regression of least ordinary squares. Thus, the common line equation is as follows:
 $Profitability_{i,t+2} = \beta_0 + \beta_1 Conversation_{i,t} + \beta_2 Avg. Profitability_{i,t} + \beta_3 Std.Dev Profitability_{i,t} + \beta_4 Leverage_{i,t} + \beta_5 Growth_{i,t} + \beta_6 Size_{i,t} + \beta_7 R\&D + ADV_{i,t} + \beta_8 Past_{i,t} + \epsilon$

Multi –variable Model Regression Analysis for the Cost of Special Future Items

Table 1-6 The Model Summary

method regression	R	2R	Adjusted R2	Standard deviation
<i>square the least common</i>	0/459	0/211	0/192	0/244

As it is clarified in the table above, the correlation coefficient of multi-variable is considered in which the cost of the coming year’s specific items in dependent and independent variables of conservatism, Past, ROE mean, ROE standard deviation, leverage, growth and size are included. In regression method, the least common square is 0/211. Therefore, it can be mentioned that in regression method, the least common square explains 21% of the changes made in future specific items by the independent variables of this model. This model is not able to explain about 89% of the changes made in the costs of specific items by regression method in the least common square. In this model, the adjusted R2 equals 0/192 and standard error of model measurement is 0/244.

Table 1-7 significant test of multi-dimensional regression

method		Total squares	degree of freedom	Squares mean	F	Significance level
the least common squares	Regression	4/661	7	0/666	11/162	0/000
	Remained	17/419	292	0/06		
	Total	22/08	299			

According to this table, there has been a multi-dimensional significant test. With regards to the fact that F (11/162) is in located in the accepted and certain distance (error less than 5%), the gained R2 is significant .Thus, with 95% degree of certainty, it can be mentioned that 21% of the changes in the cost of future specific items is explained by this model by the use of regression in the least common square.

Regarding table 5-1, the common regression equation and standard of the model can be written based on the regression of the least common square. The equation is as follows:

$$Future_{i,t} = \beta_0 + \beta_1 Conversation_{i,t} + \beta_2 Past_{i,t} + \beta_3 Avg. ROE_{i,t} + \beta_4 Std. Dev ROE_{i,t} + \beta_5 Leverage_{i,t} + \beta_6 Growth_{i,t} + \beta_7 Size_{i,t} + \epsilon$$

RESULTS OF THE TESTED HYPOTHESES

The results of the current study demonstrate the followings by the use of common correlation coefficient and linear regression of the least common square:

The First Hypothesis:

H0: The level of conservatism has no significant effect on the future profit making of firms.

H1: The level of conservatism has a significant effect on the future profit making of firms.

Regarding different studies about the effect of conservatism variable on the future profit earnings of firms by the use of the mentioned statistical methods, the results of the regression in the least common square indicate a weak and insignificant effect at the certainty level of 95% for the operational cash. Thus, the H0 hypothesis cannot be rejected at the significant level of 5%. On the other hand, the obtained results from the profit margin model depict a significant effect at the certainty level of 95% for the profit margin. So, H0 hypothesis can be rejected at the significant level of 5%. By the certainty degree of 95%, it can be mentioned that the level of conservatism has significant and positive effect on the future profit making of firms.

So there is significant effect between the level of firms conservatism and the margin of the future profits of the accepted firms in Tehran Stock Exchange, but there is no significant effect between firms conservatism and the operational cash of the accepted firms in Tehran Stock Exchange. Therefore, the firms which have a higher level of conservatism have more profit margin. On the other hand, the level of conservatism has no effect on the future operational cash.

The Second Hypothesis:

H0: The level of conservatism has no significant effect on the less identification of future specific items.

H1: The level of conservatism has a significant effect on the less identification of future specific items.

All the study using various methods involving common correlation and regression of the least common square indicate that the level of firm conservatism has an insignificant effect on the identification of the cost of the future specific items at the certainty level of 95%. Thus, by the use of the regression of the least common square, H0 cannot be rejected at the significant level of 5%. Therefore, it cannot be concluded that the higher level of conservatism leads to the report of less future specific items in the accepted firms in Tehran Stock Exchange. The level of conservatism has no significant effect on the less identification of future specific items as cost at the certainty level of 95%.

Conclusions

Scott Duellman and Anwer Ahmet carried out a study in 2010 entitled "Evidence on the Role of Accounting Conservatism in Monitoring Managers' Investment Decisions". They came to the conclusion that concerning the firms with less accounting conservatism, the firms with more accounting conservatism significantly have higher profitability within three-years in future. Furthermore, they found out that the firms with less accounting conservatism significantly have a lower probability of taking into account specific items as costs. Considering specific items as costs is significantly lower than the firms which use less accounting conservatism. Their tests demonstrated controlling the impact of effective factors on future profitability and costing specific items in previous studies including size, leverage, growth opportunities, variability of profits, and industry. Totally, the evidence is consistent with the role of conservatism in corporate governance predicted by Watts (2003) and Ball and Shivakumar (2005).

Thus, the results can be mentioned in this way. According to the first hypothesis, the effect of the conservative variable on firm profit earning at the significant level of 5%, in case of selecting the operational cash as the representative of profit making, is not prominent and cannot be set as the criterion to determine the levels of conservatism, while the effect of conservative variable on the future profit making, in case of selecting profit margin as the representative of profit making at the significant level of 95% is prominent. Leverage variables coefficients, growth, size, total costs of research, development and advertisement and Past, in case of choosing each of the profit making representatives, were insignificant in conservatism variables and show no impact on conservatism levels. However, the conservative variable coefficient, in case of choosing the operational cash at the certainty level of 95%, is not important, though in case of selecting margin profit at the significant level of 5% , is important. It is worth mentioning that the variable coefficient of profit making mean and standard deviation of profit making at the significant level of 5% is prominent.

The result of the second hypothesis by the use of the regression in the least common square depicts that conservatism is not significant at the level of 5%.

Therefore, the significant level of conservatism in the accepted firms of Tehran Stock Exchange does not affect future operational cash, but does affect firm margin cash. It can be argued that the firms with higher level of conservatism gain more profit in comparison with the firms having lower level of conservatism. But the level of conservatism has no effect on the operational cash of firms. Also, the level of conservatism does not cause less identification of specific items as cost; in other words, the level of conservatism does not affect the identification of specific items as cost.

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