

Study of Relationship between Ownership Concentration and Accounting Conservatism

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ABSTRACT

Conservatism is an apparent feature of financial reporting that is mixed with accounting theory and practice. Conservatism has been a dominant feature in accounting area and financial reporting since early 20th century. Regarding to the importance of accounting conservatism concept, the goal of this research is to study of relationship between ownership concentration and accounting conservatism in companies accepted in Tehran Stock Exchange. A sample of 74 companies was selected for 2006-2010 (5 years). Linear regression was used to test assumptions and study of relationship between ownership concentration and accounting conservatism in confidence level 95%, and SPSS and Excel software. The results showed that there is negative (reverse) relationship between ownership concentration and accounting conservatism.

KEYWORDS: Accounting conservatism, ownership concentration, profit quality.

1. INTRODUCTION

One of the most important features of new capital markets, especially in developing countries, is large investors and acquisition of a great part of firm ownership rights by them. Iran is not an exception. Presence of large investors including large governmental organizations and financial institutions in capital market brings this question to mind that whether ownership structure can affect offering qualitative financial information, which make market more efficient and cause better decision-making and better capital assignment to industries with higher value added; or changes must be applied in capital assignment between stockholders, especially institutions, organizations, and large companies?

The results of this research help us answer this question and understand whether it is necessary to change ownership structure of firms or apply limitations for some stockholders to obtain a more effective market? In the recent years, ownership structure and its effect on different aspects of companies, including profit quality, were the most important problems in the related corporation governing literature, especially among developing economies and new European and Asian markets. However, effect of corporation leadership system on conservative activities of companies has not been developed well. The main question is that whether ownership concentration (or dispersion) affects accounting conservatism? Therefore, the main goal of this research is to study relationship between ownership concentration and accounting conservatism.

2. A REVIEW ON THE LITERATURE

There are many definitions for conservatism in accounting literature. Basu (1997) defined conservatism as having a high degree of confirmation to recognize good news such as profit, against recognition of bad news such as loss. This definition describes conservatism from its profit and loss view (Basu, 1997). Another definition is the balance sheet view. According to this view, when there is a doubt for selection of several reporting methods, the method must be selected that has least desirable effect on rights of stockholders (Feltham & Ohlson, 1995). The third definition is the combinational view of balance sheet and profit & loss. By this view, conservatism is an accounting concept that causes decrement of reported accumulated profit by late recognition of income and early recognition of cost (Givoly & Hayn, 2000).

Conservatism is a criterion to measure profit quality. Profit quality is a multi-dimensional concept which there is no consensus about its definition in the literature. Vincent & Schipper (2003) consider several concepts as profit quality that stem from profit time features: stability, anticipation capability, and volatility (Vincent & Schipper, 2003). Watts (2003) considers profit quality as relation of past profits of company with future cash flows, and thus note to the anticipation value (Watts, 2003). Velury & Jenkins (2006) use qualitative features of financial statements, such as relativity and reliability, as profit quality (Velury & Jenkins, 2006).

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In this essay, if we assume conservative profit quality in compliance with the literature, we can use the literature and hypotheses for relationship between ownership concentration and profit quality.

There are three hypotheses about relationship between ownership concentration and profit quality:

The first hypothesis is “active monitoring”. Followers of this hypothesis argue that blockers are investors with long-term view that have great motivation and ability for active monitoring (Brous & Kini, 1994). Followers of this hypothesis mention two reasons: First, although stockholders can sell their capitals, but their capitals are so large that may affect stock prices and cause value decrement. Therefore, they oblige to accept a long-term strategy and this motivates them for active monitoring. Second, blockers are more capable than little stockholders to evaluate financial statements, because most of them are institutional investors and large organizations. For example, Hand (1990) concluded that experienced investors could interpret information of expressed profits more precisely (Hand, 1990). They believe that ownership concentration causes blockers correct behavior of managers toward non-qualitative profit reports and apply more conservatism.

There are two competitor hypotheses against active monitoring hypothesis: 1. private benefits hypothesis, 2. strategic union hypothesis. Followers of private benefits hypothesis believe that it is more probable that large investors use special benefits such as confidential information for transactions (Kim, 1993).

If this hypothesis is true, blockers may not be encouraged to stimulate manager for conservative profits, and this may show a negative relationship between ownership concentration and conservatism. To support the negative relationship between ownership concentration and conservatism, the strategic union hypothesis says that blockers and managers perceive mutual cooperation useful and this cooperation decreases monitoring task, which may increase value of company, and affect perception of other stockholders about profit quality, because they suppose near relationship between managers and blockers is deemed as their exploitation, and so we see a negative relationship between ownership concentration and conservatism (Pound, 1988).

3. Research history

Nekounam *et al.* (2011) in a research titled “study the relationship between ownership structure and information asymmetry” suggested that difference of ownership structure justified information asymmetry. They concluded that increment of institutional ownership, managerial ownership, and ownership concentration may increase information asymmetry, but increment of corporation ownership may decrease ownership asymmetry (Nekounam *et al.*, 2012). Chi *et al.* (2009) in a research titled “relationship between corporation ownership and conservatism” used the model of Khan & Watts (2007) to measure accounting conservatism. In companies of Taiwan’s bourse for 1996 to 2004, they concluded that companies that their stocks belonged to institutional stockholders needed less to conservative accounting (Chi *et al.*, 2009). Velury & Jenkins (2006), in study of relationship between institutional ownership concentration and profit quality concluded that concentrated institutional ownership had a negative relationship with most profit quality criteria (Velury & Jenkins, 2006). Astami & Tower (2006) studied company features and accounting methods in Pacific Asia (Australia, Hong Kong, Indonesia, Singapore, and Malaysia). The results showed that low financial lever, low ownership concentration (more ownership dispersion), and much investment opportunities conclude more conservative actions in financial statements. Of course, these results were established when two variables of industry and country were not considered. The control variable for country was more effective than the other variables. Their results showed that Malaysian companies interested to conservatism (Astami & Tower, 2006).

Beekes *et al.* (2004) in a research titled “relationship between on time profit, profit conservatism, and combination of board of directors” considered conservatism and on time profit as accounting quality criteria. Using a sample from England and asymmetric time profit model by Basu (1997), they concluded that companies that their members of board of directors are more independent, are more conservative. Thus they concluded that combination of members of board of directors was an important factor to determine profit quality in English companies (Beekers *et al.*, 2004).

Ahmed & Duellman (2008) in another research concluded that accounting conservatism prevented investment of managers in projects with negative return. Also, they understood that there was a direct relationship between stock percentage of members of board of directors and conservatism (Ahmed & Duellman, 2008). Givoly & Hayn (2000) showed that profitability had decreased in USA during the last decade. However, this decrement hadn’t decreased cash flows. Their results showed that loss was distinguished faster than profit, and non-conditional conservatism and loss reporting had decreased to 35% in financial reporting of USA (Givoly & Hayn, 2000). Klein & Marquardt (2006) showed that there was a direct relationship between increment of non-conditional conservatism and loss increment of companies. They found a direct relationship between conservatism and loss during a 50-years period (the second half of 20th century) in USA, and they confirmed the results of Givoly & Hayn (Klein & Marquardt, 2006).

In another research, Rezazadeh & Azad (2008) studied relationship between accounting conservatism and information asymmetry for 2002-2006. Their results showed a positive and significant relationship between

information asymmetry among investors and accounting conservatism. They also concluded that changes in information asymmetry among investors change conservatism level (Rezazadeh & Azad, 2008). Sassan Mehrani et al (2010) studied relationship of institutional ownership and conservative accounting. They concluded that companies desired to use conservative procedures by increment of institutional ownership level (Mehrani et al, 2010). Mahdi Moradzadeh et al (2009) studied relationship between institutional ownership and profit management. In this research, they studied relationship between institutional investors and profit management and concluded that there was a negative relationship between institutional ownership of stocks and profit management (Moradzadeh et al, 2009). Sohrab Asta (2011) in a research titled “study of relationship between ownership structure and profit management” suggested that difference in ownership structure justified profit management. Their results showed a negative relationship between institutional ownership and managerial ownership with profit management, but there is a positive relationship between corporation ownership and profit management (Asta, 2011).

4. Research assumption

The following assumption was tested to achieve the research goals:

Assumption: There is a relationship between ownership concentration level and accounting conservatism.

5. RESEARCH METHODOLOGY

This is an application research by goal and a descriptive-correlation one by method and nature. The goal of this research is to study the relationship between ownership concentration (independent variable) and accounting conservatism (dependent variable). Linear regression was used to examine the relationship between these two variables. The assumption was examined by confidence level 95%. The non-linear relation between the variables was also tested. Regarding to F statistic value and the significance level, it was found that linear regression was the best fit for these variables.

5.1. Data gathering

In this research, library method was used to gather data. Research tools included financial statements, associated footnotes, and financial reports gathered from Rahavard Novin software and Tehran Stock Exchange site. After classification of variables in Excel, data was analyzed by SPSS.

5.2. Research model and measurement of variables

The Astami & Tower’s (2006) model was used to study the relationship between ownership structure and accounting conservatism:

$$\text{CONSER}_{it} = \alpha + \beta_1 \text{BLOCK}_{it} + \beta_2 \text{SIZE}_{it} + \beta_3 \text{LEV}_{it} + \beta_4 \text{GROWTH}_{it} + \beta_5 \text{MBV}_{it} + \varepsilon_{it}$$

in which,

CONSER _{it}	: Accounting conservatism index for firm i in period t
BLOCK _{it}	: Ownership concentration of firm i in period t
SIZE _{it}	: Size of firm i in period t
LEV _{it}	: Financial lever of firm i in period t
GROWTH _{it}	: Growth index of firm i in period t
MBV _{it}	: Market value to book value of return volatility of firm i in period t
ε _{it}	: Error term for firm i in period t

5.2.1. Independent variables

Ownership concentration level (percentage of stocks of blockers): Percentage of published stocks in hands of five large stockholders.

5.2.2. Dependent variable

Givoly & Hayn’s (2000) model was used to measure accounting conservatism index. This index is calculated as follows:

$$\text{CONSER} = \frac{\text{OACC}}{\text{TA}_{t-1}} \times (-1)$$

in which,

CONSER	: Accounting conservatism index
OACC	: Operational accruals
TA _{t-1}	: Sum of assets at beginning of period

5.2.3. Control variables

1. **Firm size:** In this research, firm size is \ln [sum of assets at end of period]
2. **Financial lever:** Total debts to total assets at end of period
3. **Growth index:** Asset changes to beginning of period assets
4. **Market value to book value:** Value of stocks market at end of period to book value of equity, according to the literature

6. Research society and statistical sample

The society of this research includes all companies accepted in Tehran Stock Exchange for 2006-2010 with the following conditions:

1. The company was accepted in Tehran Stock Exchange before 2006.
2. End of financial year of each company is March 20.
3. Trading days of the company are not less than 70 days.
4. A company is not a member of financial and investment companies.
5. All required data for the sample company is available.

Thus, 74 companies were selected by systematic deletion method.

6. RESEARCH FINDINGS AND DATA ANALYSIS

Data for 74 companies for 2006-2010 was extracted from Rahavard Novin software and Tehran Stock Exchange site. After classification by Excel, data was analyzed by SPSS.

7.1. Descriptive statistics

Table 1 shows descriptive statistics of variables. This table shows statistical index, number of observations, average, and standard deviation.

Table 1: Descriptive statistics of variables

Variable	Observations	Average	SD
Ownership concentration level	370	0.60	0.37
Firm size	370	4.563	0.762
Financial lever	370	0.128	0.155
Growth index	370	1.526	0.152
Market value to book value	370	1.635	0.234
Accounting conservatism index	370	-0.68	0.133

7.2. Test of normalization of dependent variable

Normalization of dependent variable distribution is one of the basic assumptions of correlation method. Thus, here we examine this by Kolmogorov-Smirnov Test. The results are shown in table 2. Since importance level of dependent variable is 19.8%, namely more than 5%, the dependent variable has a normal distribution. Thus, it can be concluded that the rest of regression line has a normal distribution and has not variance deviation.

Table 2: Kolmogorov-Smirnov Test

Accounting conservatism index	Description
Number of observations	370
Kolmogorov-Smirnov statistic	1.075
Significance level	0.198

7.3. Assumption test results

The findings in table 3 show that the factor of independent variable (ownership concentration) in negative and significant in regression pattern. Since sig (significance) of statistics T and F in the model are less than 5%. This shows rejection of assumption H0 and acceptance of assumption H1, and indicated acceptance of research assumption. Then, generally there is a reverse (negative) relation between ownership concentration level and accounting conservatism. That is, the more the ownership concentration, the less the accounting conservatism. Therefore, the research assumption is confirmed. This result complies with those of Velury & Jenkins (2006), Astami & Tower (2006), Nekunam et al (2011), and Asta (2011).

Table 3: The results of research assumption test

CONSER _{it} = $\alpha + \beta_1$ BLOCK _{it} + β_2 SIZE _{it} + β_3 LEV _{it} + β_4 GROWTH _{it} + β_5 MBV _{it} + ϵ_{it}								
Dependent variable (Accounting conservatism)	Dependent variable (Ownership concentration)		Variance analysis	Determination power			Durbin-Watson statistic	Result
	Coef.	T (sig)	F (sig)	R	R ²	Adjusted R ²		
CONSER	-2.048	-6.805 (0.000)	44.674 (0.000)	0.617	0.380	0.372	1.968	Confirmed

8. DISCUSSION AND CONCLUSION

In this research, one of the effective factors in corporation ownership, namely, ownership concentration in management activity of accruals and accounting conservatism was tested in companies accepted in Tehran Stock Exchange in a five-year period. About ownership concentration, as mentioned in the assumption test, there is a negative and significant relationship between ownership concentration and accounting conservatism by confidence level 95%. In the theoretical framework, it was expressed that by ownership concentration near little stockholders, management power for applying profit increment methods will decrease, because if ownership of a company belongs to the stockholders that are many but have little ownership, a manager can easily apply his power. On the other hand, the private benefits hypothesis suggests that large stockholders penetrate reporting because they hold many stocks. They apply pressure on managers to increase profit and increase of stock price, which affect conservatism reversely. The obtained result also complies with this theory. On the other hand, if we consider conservative benefit as a criterion for profit quality (according to the literature), we conclude that ownership concentration decreases conservatism and profit quality. This result complies with the strategic union hypothesis.

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