The Study of the Relationship between Optimistic Estimates of Future Stock Returns by Managers and Accounting Conservatism in Firms Accepted in Tehran Stock Exchange

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Received: November 12, 2015
Accepted: February 23, 2016

ABSTRACT

This paper examines the relationship between accounting conservatism and optimistic estimates of future stock returns by managers. The statistical population of the study consisted of all firms listed on the Stock Exchange of Tehran and a sample survey of 128 firms selected using a systematic elimination method in the period 2009 to 2013. In order to test hypotheses, correlation and regression analyses of data were statistically used. The results of testing hypotheses suggest that there is a significant positive correlation between unconditional conservatism and optimistic estimates of future stock returns by managers, but there is no significant relationship between the optimistic estimates of future stock returns by managers of public firms and accounting conservatism.

KEYWORDS: optimistic estimates, conservatism, conditional conservatism, unconditional conservatism, future stock returns

INTRODUCTION

Conservatism is one of the desirable characteristics of accounting that through the rule “do not anticipate any profit, but predict all losses” indicates this issue that preferably the lowest values for assets and revenues and the highest level of expenses and liabilities should be considered in the framework of financial statements. In relation with the necessity of using the concept of conservatism in accounting, it is said that the optimistic view of management in financial statements is reflected and the possible losses resulting from this optimistic view can be important. As a result, accounting reduces the scale of potential losses with a conservative approach to financial events. Procedures which result in less discretionary understatement the assets or income or overstatement of liabilities or costs are not within the scope of the principle of conservatism. These procedures reduce the desirable amount of information characteristics, such as impartiality, fair presentation and reliability of accounting data and should be treated as earning management practices. In such a case, the objectives of these procedures are not based on protecting investor, but they are responses for personal motivation of management. On the other hand, the study of the effects of managers’ overconfidence on firm practices includes accounting procedures. Overconfidence can lead to future incorrect decision and distortion of appropriate investment policies, financial or accounting supply and impose exorbitant costs on firms, but the firm’s overconfidence can have benefits in some circumstances. For example, the motivation of overconfident managers to take risk is less expensive than other managers. Overconfident managers overestimate the future stock returns arising from the firm’s investment projects. Therefore, it may delay recognition of losses and may have optimistic estimates in determining the value of current or long-term assets. Thus, overconfidence of management can lead to lower levels of conditional and unconditional conservatism in prediction. Managers’ predictions due to several consequences which have in the market and managers’ particular attention to the implications are important. Predictions provided by the managers about the future profitability of the firm have valuable potentials that contribute investors to take optimized decisions. The value of these predictions depends on the accuracy and credibility of them from the perspective of customers. In an uncertain environment, managers’ assessment about the perspective for the firm’s activities is incomplete. The effects of this uncertain environment could be reflected in accruals and thus lead to errors in the management’s assessment of future earnings. Business environment of a firms full of uncertainty due to changes in business conditions (such as unpredictable changes in market demand and strategies of competitors). These uncertainties suggest that the managers’ knowledge of the business perspective of the firms is insufficient. Managers’ predictions have errors that are resulted from their inadequate assessments of the firm’s prospective. In addition, uncertainty in the business environment can induce or

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aggravate the managers’ bias in the data processing. Studies on the effects of managers’ overconfidence (optimism) are important from the perspective of policies of a firm, including accounting policies. One of the classifications made in relation to the concept of conservatism is the category of conditional and unconditional conservatism. Conditional conservatism is a conservatism that is required by accounting standards. That is, the profits reflect bad news faster than good news that leads to timely identification of losses. This type of conservatism is also called the profit and loss conservatism or retrospective conservatism. Unconditional conservatism is not required by generally accepted accounting standards. This kind of conservatism is the understatement the net book value of assets due to predetermined accounting procedures. It is also known as prospective conservatism (Banimahd and Baghban, 2009). Several studies have been done on the concept of conservatism. Ahmad and Duellaman (2013) in a study to evaluate the effects of overconfidence of management on accounting conservatism concluded that the overconfidence has a negative effect on accounting conservatism and the external monitoring will not reduce these negative effects. Otomasa et al. (2012) studied the relationship between conservatism and the rate of managers’ reward in Japan and concluded that accounting conservatism has a negative relationship with the rate of managers’ reward and reduces managers’ reward. They have also found that this relationship is more in institutions in which the reward is a large multiplication of the interest. Libby and René-Kamp (2012) in a study to investigate the effect of management overconfidence the issuance of profit forecasts concluded that management overconfidence is effective in decision on the issuance of profit forecasts. An overconfident manager believes in the firm’s future positive performance which increases the tendency to increase the issuance of profit forecast. Iyengar and Zampelli (2010) studied the effect of accounting conservatism on the relationship between executive managers’ reward and the paid accounting profit and concluded that accounting conservatism considerably increases the relationship between changes in profits and changes in the rewards. Lee (2010) in a study to examine the role of accounting conservatism in financial decisions concluded that firms with higher accounting conservatism show less flexibility in liquidity management and decisions related to the issuance of shares. Malmendier and Tate (2008) in a study investigated the effect of overconfidence in investing in US firms and concluded that overconfidence leads to excessive investment and overconfident managers are more intended to obtain firms which results in a decrease in the value over time. In addition, when the managers have access to internal funds and need not to have external financing, the effects will be stronger. Klein and Marquardt (2006) studied the relationship between conservatism and the firms’ losses and concluded that there is a direct relationship between the increase in unconditional conservatism and increase of firms’ unprofitability. Farooqi and Nokhbeh-Fallah (2014) in a study to evaluate the effect of managerial overconfidence on conditional and unconditional conservatism and concluded that the effect of managerial overconfidence on conditional and unconditional conservatism is negative and significant; in other words, the existence of overconfidence characteristic in senior managers reduces the conservatism in the process of financial reporting. Ramsheh and Mollanazari (2014) examined the relationship between accounting conservatism and overconfidence of management and by studying the external monitoring effects on this relationship concluded that there is a negative significant correlation between conditional and unconditional conservatism and management overconfidence. In addition, the results demonstrated that external monitoring reduces the negative effect of overconfidence on conditional conservatism, but does not have a similar effect on unconditional conservatism. Fakhari and Rasouli (2013) in a study evaluated the effect of conservatism and accrual quality on investment efficiency and concluded that conservatism actions increase the efficiency of the firms’ investment. Thus, the objective of this study is to investigate the relationship between accounting conservatism and optimistic estimates of future stock returns by managers.

Research hypotheses

*Hypothesis 1:* There is a significant negative relationship between conditional conservatism and optimistic estimates of future stock returns by managers.

*Hypothesis 2:* There is a significant negative relationship between unconditional conservatism and optimistic estimates of future stock returns by managers.

*Hypothesis 3:* The relationship between accounting conservatism and optimistic estimates of future stock returns by managers of public firms is stronger than the relationship between accounting conservatism and optimistic estimates of future stock returns by managers of non-governmental organizations.

RESEARCH METHODOLOGY

The present research is an applied one in terms of objective, which its results can be applied to a wide range of investors in financial markets, stock exchange officials, portfolio managers, shareholders, the stock exchange agencies, financial analysts and market researchers to provide informational transparent space, portfolio design optimization, contribution to optimized investment decisions in the stock market and providing new research
horizons; and it is a descriptive (quasi-experimental) research of correlation type in terms of nature; and in order to analyze data, the statistical tools including correlation tests and regression analysis were used. The used research design is the post-event design and each of the research hypotheses has been tested using real information which has been obtained based on the actual performance of Tehran Stock Exchange during the time period of the research. The study population consisted of all firms accepted in the Tehran Stock Exchange in the time period of 2010-2014. To test the hypotheses, first all firms accepted in the Tehran Stock Exchange were listed up to the end of 2014 and early 2015, and using the systematic elimination rule and considering the following limitations, 128 firms were selected.

- Firms that had been accepted at Tehran Stock Exchange before 2010 and have not gotten out of the Stock Exchange by the end of 2014.
- The fiscal year of the firm must end at March [the end of Stand in Iranian calendar] each year.
- The sample firms must not involve investment firms, holding firms, banks and financial brokers.
- There is no trading interruption for more than 6 months for the firm’s stock.

Measurement of research variables

Conditional conservatism

Conditional conservatism is a kind of conservatism that is required by accounting standards, i.e. the timely recognition of losses if there is bad and undesirable news and the lack of recognition of profits when there is good news. Conditional conservatism means that the net book value of assets in adverse conditions will reduce, but not increase under favorable conditions. For example, the use of the least finished cost or net cost rule of sales in inventory valuation is a kind of conditional conservatism. This type of conservatism is called profit and loss conservatism or retrospective conservatism. Conditional conservatism is measured with Basu’s (1997) model as follows:

\[
EPS_{it} = \alpha_0 + \alpha_i DR_{it} + \beta_0 R_{it} + \beta_i R_{it} * DR_{it}
\]

Unconditional conservatism

Unconditional conservatism has not been required through accepted accounting standards. This type of conservatism is the understatement of the book value of net assets due to the predetermined accounting procedures. The conservatism is known as balance-sheet conservatism or prospective conservatism. To measure the unconditional conservatism, Givoly and Hayn model has been used. Unconditional conservatism index is calculated based on this model as follows:

Conservatism index = accruals/Total assets at the beginning of the period × (-1)

The operating accruals are obtained from the difference between net income and operating cash flow plus depreciation expense. According to Givoly and Hayn, the advance of accruals can be an indicator of change in the degree of accounting conservatism in a long period. In other words, if accruals increase, then conservatism decreases, and vice versa. Therefore, to determine the direction of conservatism the accruals are multiplied by minus one.

Measurement model of variables

\[
MF_{optim_{t+1}} = \alpha + \beta_1 ROA_t + \beta_2 MF_{optim_{t-1}} + \beta_3 MF_{SURP_t} + \beta_4 LOSS * ROA_t + \epsilon
\]

Variables of the model

- \(MF_{optim_{t+1}}\): Optimism is a dummy variable and if the prediction error (actual profit minus the first profit prediction) is \(t+1\) year is 1, and otherwise is zero.
- ROA: return of assets in the previous year; the profit before exceptional items in the year \(t\) over the total assets at the end of year.
- LOSS: If we have losses in the previous year, the factor is 1 and otherwise zero.
- \(MF_{optim_{t-1}}\): Optimism in predicting the previous year (\(t-1\) year) is a variable which is obtained from comparing the first prediction of the previous year and the actual profit of the previous year. It is a dummy variable that if the prediction error (actual profit minus predicted profit) of \(t-1\) year is negative (if prediction is optimistic), its value is 1 and otherwise the value is zero.
- \(SURP_t\): Optimism in predictions for the current year (year \(t\)), which is obtained from comparing the predictions of current year and the first prediction for the current year. It is a dummy variable that if the last prediction of the current year until the time of providing the prediction of the next year is less than the earlier prediction of the current year (if the earlier prediction of the current year is optimistic), it is 1, and otherwise is zero.
Research findings

The results of the first hypothesis test

Hypothesis 1: There is a significant negative relationship between conditional conservatism and optimistic estimates of future stock returns by managers.

In this hypothesis, the determination coefficient that defines the accuracy of the explanation of model by independent variable is equal to 0.125. This means that about 13 percent of the changes of the dependent variable (the optimistic estimate of future stock returns by managers) are explained by the model. This value is relatively low, but shows that the independent variable can explain the model. One of the regression assumptions is the independence of errors. If the hypothesis of independence of errors is rejected, and the errors are correlated with each other, there is not the possibility of using regression. Durbin-Watson test is used to study the independence of errors that if the value of Durbin-Watson test is in the range of 1.5 to 2.5, the assumption of correlation between errors is rejected, and we can use the regression that in this hypothesis, this value is 2.25 that is in the domain. Therefore, the assumption of independence of errors is accepted. Also, for determining the significance of the model, Fisher’s test is used, and since in this hypothesis the significance level of the test for variable is less than 5% (0.00), therefore, we can say that the model is significant.

Table 1. Coefficients of the regression equation for the first hypothesis

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>B</th>
<th>Standard error</th>
<th>t</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conditional conservatism</td>
<td>0.127</td>
<td>0.0309</td>
<td>4.12</td>
<td>0.00</td>
</tr>
<tr>
<td>C</td>
<td>0.433</td>
<td>0.0096</td>
<td>44.75</td>
<td>0.00</td>
</tr>
<tr>
<td>Determination coefficient</td>
<td>0.125</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Durbin-Watson</td>
<td>2.25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F (Prob.)</td>
<td>17.74 (0.00)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Dependent variable: Optimistic estimates of future stock returns by managers

Results of the first hypothesis can be seen in the table above. In this table we see that the significant level of t-test is less than 0.05, which shows that the independent variable could be effective on the dependent variable, so that conditional conservatism could lead to optimistic estimates of the amount of future stock returns up to 0.127 units. Therefore, this hypothesis is confirmed.

The results of the second hypothesis test

Hypothesis 2: There is a significant negative relationship between unconditional conservatism and optimistic estimates of future stock returns by managers.

In this hypothesis, the determination coefficient that defines the accuracy of explanation of model by independent variable is equal to 0.08. This means that about 0.08 percent of the changes of dependent variable (optimistic estimates of future stock returns by managers) are explained by the model. This amount is too low and it can be said that the independent variable does not have the ability to explain the model. One of the regression assumptions is the independence of errors. If the hypothesis of independence of errors is rejected, and the errors are correlated with each other, there is not the possibility of using regression. Durbin-Watson test is used to study the independence of errors that if the value of Durbin-Watson test is in the range of 1.5 to 2.5, the assumption of correlation between errors is rejected, and we can use the regression that in this hypothesis, this value is 2.24 that is in the domain. Therefore, the assumption of independence of errors is accepted. Also, for determining the significance of the model, Fisher’s test is used, and since in this hypothesis the significance level of the test for variable is higher than 5% (0.466), therefore, we can say that the model is not significant.

Table 2. Coefficients of the regression equation for the second hypothesis

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>B</th>
<th>Standard error</th>
<th>t</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conditional conservatism</td>
<td>0.127</td>
<td>0.0309</td>
<td>4.12</td>
<td>0.00</td>
</tr>
<tr>
<td>C</td>
<td>0.433</td>
<td>0.0096</td>
<td>44.75</td>
<td>0.00</td>
</tr>
<tr>
<td>Determination coefficient</td>
<td>0.125</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Durbin-Watson</td>
<td>2.25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F (prob.)</td>
<td>17.74 (0.00)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Dependent variable: Optimistic estimates of future stock returns by managers
The results of the second hypothesis are seen in the table above. We can observe from the table that the significance level of t-test is more than 0.05, which shows the independent variable could not affect the dependent variable. Therefore, the hypothesis is rejected.

The results of the third hypothesis test

Hypothesis 3: The relationship between accounting conservatism and optimistic estimates of future stock returns by managers of public firms is stronger than the relationship between accounting conservatism and optimistic estimates of future stock returns by managers of non-governmental organizations.

Table 3. Pearson coefficient for the third hypothesis

<table>
<thead>
<tr>
<th>Y variable</th>
<th>X variable</th>
<th>Pearson coefficient (r)</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting conservatism</td>
<td>Optimistic estimate of future stock returns by managers of public firms</td>
<td>-0.015</td>
<td>0.859</td>
</tr>
<tr>
<td>Accounting conservatism</td>
<td>Optimistic estimate of future stock returns by managers for non-governmental organizations</td>
<td>0.057</td>
<td>0.206</td>
</tr>
</tbody>
</table>

In the above table, we can see that the significance level (sig) of Pearson test (r) is not significant for the relationship between optimistic estimate of future stock returns by managers of public firms and non-governmental organizations at all. Therefore, it can be concluded that the relationship between accounting conservatism and optimistic estimates of future stock returns by managers of public firms is not stronger than the relationship between accounting conservatism and optimistic estimates of future stock returns by managers of private organizations.

Table 4. The results of testing research hypotheses

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Statement of hypotheses</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>H₁</td>
<td>There is a significant negative relationship between conditional conservatism and optimistic estimates of future stock returns by managers</td>
<td>Rejection of H₀</td>
</tr>
<tr>
<td>H₂</td>
<td>There is a significant negative relationship between unconditional conservatism and optimistic estimates of future stock returns by managers</td>
<td>Confirmation of H₀</td>
</tr>
<tr>
<td>H₃</td>
<td>The relationship between accounting conservatism and optimistic estimates of future stock returns by managers of public firms is stronger than the relationship between accounting conservatism and optimistic estimates of future stock returns by managers of non-governmental organizations</td>
<td>Confirmation of H₀</td>
</tr>
</tbody>
</table>

Conclusion

Managers’ predictions are of the utmost importance due to their various consequences on the securities market, and paying special attention to these consequences by managers. Predictions provided by managers about future stock returns have great potentials to help investors make optimal decisions and the value of these predictions depends on their accuracy and credibility from the perspective of customers. In an uncertain environment, managers’ assessment of the outlook for the firm’s activities is incomplete. The effects of this uncertain environment could be crystallized in accruals and thus lead to errors in the management’s assessment of future earnings. However, the results of the present study suggest that conditional conservatism can potentially lead to improvement of the efficiency of debt and reward contracts. In debt contracts, the earlier identification of losses compared to gains will help the lender in faster understanding the possible violation of the loan agreement that this result is consistent with that of Ball and Shivakumar (2005). Also, unconditional conservatism does not have a significant influence on optimistic estimates of future stock returns by managers. Unconditional conservatism (conservatism of balance-sheet, independent of news and related to the future) is a widespread lack of knowledge that is not related with current news communication and causes a lower value report for shareholders through the accelerating the recognition of costs. Due to same reason, it is said that unconditional conservatism is independent of the news. The results also indicate that, there is not any relationship between conservatism and optimistic estimate of future stock returns by executives of public firms compared with the estimate by the managers of private firms. As a result, the relationship between accounting conservatism and optimistic estimates of future stock returns by managers of public firms is not stronger than the relationship between accounting conservatism and optimistic estimates of future stock returns by executives of private firms. Accounting conservatism prevents any condition that may cause managers do opportunistic actions in financial reporting; therefore, the users and investors are recommended to use accounting conservatism as an appropriate criterion to ensure the of future stock returns. Also, the increase of optimistic estimates of future stock returns by executives causes the unconditional conservatism makes no directional change; so, according to this study, the optimistic estimates of future stock returns by managers are not appropriate criteria for evaluating the unconditional conservatism that can be considered by investors, and finally the consumers and investors are recommend not to make
their economic decisions based on comparing the relationship between accounting conservatism and the difference in optimistic estimates of future stock returns by executives of public and private firms.

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