

The Relationship between Conditional Conservatism and Corporate Debt Ratio among the Companies listed in Tehran Stock Exchange

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Abstract

The current paper is to study the relationship between conditional conservatism in accounting and the debt ratio in listed companies in Tehran Stock Exchange. For this purpose, a hypothesis was designed. The sample in this study was the companies listed within a 4-year period between 2008 and 2011. Regarding the limitations, 152 companies were chosen. In this study, to measure conservatism Ahmad-Dolman Model (2007) was used. Statistical tests used in this study were conducted using SPSS software in accordance with Kolmogorov- Smirnov test. The results show that there is a direct relationship between conservatism and debt ratio.

Keywords: Accounting conservatism, Ahmad-Dolman (2007), debt ratio

Introduction

In this paper, it is tried to study the relationship between accounting conservatism and debt ratio in the listed companies in Tehran Stock Exchange. Baso (1997) defines conservatism as a bigger obligation to recognize good news rather than bad news. This leads to a situation in which the revenue is shown less than what it is and in turn the assets are shown less than what they actually are. Iranian Accounting Association's Technical Committee claims that people who prepare financial statements are faced with inevitable ambiguities preparing those statements. There are some examples of those ambiguities such as maturity, probable life cycle of the asset, and the number and size of claims guaranteeing sold goods. These situations are dealt with considering a bit of conservatism and through studying the nature of the situation. Precaution is a degree of care on which accounting calculations must be based so that incomes and assets are shown more than the real amount and debts and costs less. In fact, conservatism is a consequence of ambiguity. Whenever accountants are faced with ambiguity, they cling to conservatism. This committee suggests that this conservatism must not result in aggregation of some latent resources and should not let accountants show the assets and incomes less than the real amount or to show debts and costs more intentionally. Preparation of financial statements believe that conservatism is an effort to choose one of the accepted accounting codes to reach one of the followings (Shabahang, 2008, p.54):

- Slower recognition of the income
- Faster recognition of the cost
- Lower assessment of assets
- Higher assessment of debts

In the abovementioned definitions, there is a common point which is the reference to the effectiveness of conservatism on the process of decision making by the users of financial statements. The point is to prevent bad decisions by the users and investors. The representativeness theory which relates managers' salary to the profit, managers have a strong incentive to hide bad news which lowers the profit. Then conservatism can be defined as a mechanism to control managers' incentive to show unreal amount of profit (Shorvazi and Khandozi, 2008).

Watts (2003) believes that accounting conservatism comes from economic reasons and finds the four primary reasons as the reason to use conservatism. He believes that contractual point of

view has an old history older than any other viewpoint. Meanwhile, law suits have become popular in America from 1960s after shareholders started to sue companies and the tax view point started in 1909 after some entities tried to lower their taxes. Conservatism viewpoint was started following American Stock Exchange Committee's request in 1933 and 1934.

Research background

In an study, Baso (1997) studied the effects of conservatism on financial statements. He defines conservatism as "the tend toward recognition of bad news sooner than the good ones. The bad news being recognized sooner means that the profit is more sensitive to bad news rather than the good ones. He showed that the profit is more sensitive to negative outcomes 2-6 times more than the positive outcomes. Furthermore, he showed that the profit fitting in a timely manner is mostly due to recognition of the bad news in a timely manner in accruals. On the other hand, accruals and cash flows are the same in the recognition schedule in financial statements. Felsam (2009) studied the relationship between competitive structure and conditional conservatism. He concluded that the intensity of conservatism is a factor for companies to apply conservatism. The results of his study showed that conservatism is a response to competition. Also, companies use a lower level of conservatism before they issue their shares. Bani Mahd (2006) studied the methods to measure conservatism. In his sample, which were the companies listed in Tehran Stock Exchange from 1994-2005, conservatism decreased due to the decrease in cash outcome of the assets and also the increase in long-term debts decreases conservatism. Other finding in this study was that as operation grow bigger in the company conservatism increases. Bani Mahd (2011), also conducted a study on the effects of conservatism on debts to find out that conservatism increases debts.

Methodology

In this study to gather the information on theoretical discussions, library resources like books, magazines, and technical websites on accounting were used. To gather information and data needed for the study survey was used regarding the historical information. The population in this study were the companies listed in Tehran Stock Exchange in a four year period between 2008 and 2011.

The criteria to choose the sample were that the fiscal year for the sample must end in 29th of March, their operation must be continuous, their financial statements must be audited, the government must not be the owner of the company, and they must be listed in <http://www.codal.ir>.

Due to limitations, 152 year/company were chosen as the sample in a period of 4 years from 2008 to 2011. First, the information needed from the sample were exploited from <http://www.codal.ir> and then they were recorded in Excel 2007 for further calculations. Calculations in Excel included conditional conservatism index according to Ahmed-Dolman Model 2007, and the debts ratio. In the next step, the outcomes of Excel were transferred to SPSS software for further analysis.

Hypothesis of the study

The hypothesis of the study is designed as follows

There is a relationship between conditional accounting conservatism according to Ahmed-Dolman Model 2007 and the debt ratio in listed companies in Tehran Stock Exchange.

The variables of interest

In this paper, there are two kinds of variables namely independent and dependent variables. The independent variable which is conditional conservatism index according to Ahmad-Dolman Model 2007 and is calculated from the equation below:

$$\text{conditional conservatism index} = \frac{(\text{net profit} - \text{operational cash flows})}{\text{total assets}} \times (-1)$$

The dependent variable on the other hand is the debt ratio which can be calculated through the equation below:

$$\text{debt ratio} = \frac{\text{total debts}}{\text{total assets}}$$

The statistical tests

The statistical tests used in this study which were conducted using SPSS software were:

1. Kolmogorov- Smirnov test for the normality of the data
2. Pearson test to find the coefficient and intensity of the correlation between the two variables.

The findings of the study

Whereas all statistical tests are based on the assumption that the distribution is normal in the data, it is recommended that before any further tests normality is tested using Kolmogorov-Smirnov test. In this test, if the significance level is less than the hypothesis is rejected with 95% of confidence. Kolmogorov- Smirnov test was conducted as table 1.

Table 1. One-Sample Kolmogorov-Smirnov Test

		Conditional conservatism	Debt ratio
N		152	152
Normal Parameters ^{a,b}	Mean	.0000	-1.9465
	Std. Deviation	1.00000	1.50569
Most Extreme Differences	Absolute	.131	.158
	Positive	.131	.120
	Negative	-.127	-.158
Kolmogorov-Smirnov Z		1.620	1.069
Asymp. Sig. (2-tailed)		.010	.204
a. Test distribution is Normal.			
b. Calculated from data.			

In this table, due to the fact that Sig>0.05, then normality is approved with 95% level of confidence.

To study the relationship between conditional conservatism and debt ratio, Pearson test was used (table 2). If the correlation coefficient is zero between the two variables the relationship between them is positive. And in case the correlation coefficient is less than zero, the relationship is negative. It is worth mentioning that sampling was conducted so that the correlation coefficient is significant. Correlation is not a cause and effect relation and only shows the intensity of the relationship. In the outcome table of this test there is a correlation coefficient and a significance level. If the sig. level is lower than the error level then the correlation coefficient is significant. Whereas this tests is always conducted with a 5 error level, if the level of significance is lower than 5 then the correlation coefficient is significant.

Table 2. Pearson test for the relationship between conditional conservatism and debt ratio

		Conditional conservatism	Debt ratio
Conditional conservatism	Pearson Correlation	1	.552**
	Sig. (2-tailed)		.000
	N	152	152
Debt ratio	Pearson Correlation	.552**	1
	Sig. (2-tailed)	.000	
	N	152	152

** Correlation is significant at the 0.01 level (2-tailed)

The outcome in the table above shows that $r = 0.552$ for the correlation coefficient which shows a direct relationship between the two variables so that the increase in the conditional conservatism results in the increase in the debt ratio. In this table, the highlighted point is the significance level which is 0.000 which is lower than 5%. This number shows that there indeed is a relationship between the two variables of the study. Therefore the hypothesis is approved by 95% of confidence.

Conclusion

The findings of this study show that there is a relationship between conditional accounting conservatism according to Ahmad-Dolman Model 2007 and the debt ratio of the companies.

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