

Investigating the Relation between Conservatism in Different Accounts (Accounts Receivable, Accounts Payable) and Future Operating Cash flow: Evidence from Iran

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Abstract: Efforts have been made in this paper to investigate the relation between conservatism in different accounts and future operating cash flow. Also in this paper the companies listed on the stock exchange as well as sufficient number of samples during 2002 to 2011 were randomly selected. Auditing financial statements were used for this purpose. Considering the research results it can be relatively said that future cash flow may be anticipated better by using net profit. This is because accounting income is comprehensive and includes accrual items while net cash flow is only related to cash flow. The results of this research indicate a significant relation between the changes of some of the profit accrual items and next year operating cash flow.

[Hassan Zohdi, Abdolghafour Mohammadzadeh, Mahdi Toujgi Zabol, Ahmad Taheri Nezhad, Alireza Dehvari. **Investigating the Relation between Conservatism in Different Accounts (Accounts Receivable, Accounts Payable) and Future Operating Cash flow: Evidence from Iran.** *J Am Sci* 2013;9(3):126-129]. (ISSN: 1545-1003). <http://www.jofamericanscience.org>. 17

Keywords: Conservatism Accounts Receivable, Accounts Payable, Accrual Items

1. Introduction:

According to the common theoretical frameworks in financial reporting, one of the fundamental goals of financial reporting is the usefulness of information provided in the direction of making decisions by users of financial statements. One of the subjects in decision making is their much effort to anticipate the results obtained in the future. As stated by the Iran Accounting Standards Formulation Board, "Making economic decisions by financial statement users require evaluating the capability of the commercial unit to provide cash and its certainty." In this regard, financial accounting standard board believes that providing information for investors, creditors and others to help them anticipate the value and schedule future cash flow is one of the basic goals of financial reporting. (FASB; 1978) It is evident that the contents and format of financial and accounting reports should be in such a manner to meet the above goal. On the other hand, it is logical to adopt reasonable and correct assumptions and procedures in preparing the reports to assist users in achieving the aforesaid goal.

Literature Review:

Conservatism covenant is too comprehensive to be ignored by any standardization board. Even financial accounting standard board that has not included that in the qualitative characteristics of accounting information believes that conservatism

in accounting procedure is inevitable (Mojtahedzadeh; 2001). Some reasons have been provided to emphasize on the importance of conservatism. The first reason is that applying least cost price or market value results in decreasing the value of balances in terms of property tax payment. Moreover, accountants can resist against the expectations of managers who intend to raise the value of properties or profit to increase the share price. From the viewpoint of representation theory that links managers' salaries to the reported profit; managers have a high motivation to hide bad news which reduces the profit. Conservatism can therefore be considered as a mechanism for controlling managers' motivations to provide exaggerative reports (Shabahang; Reza, 2001). Robert Sterling (2004) says, "Whenever conservatism is contradiction to an accounting principle, it will overcome that principle." Penman and Zjang (2002) made a study titled "The Relation between Conservatism, Profit Quality and Stock Yield". They defined profit quality as a profit before deducting unexpected items specified in the profit and loss statement that will have a high quality if serving as a good index for anticipating future profits. Their findings showed that conservative procedures would lead to high quality profits. Conservatism reduces profit and conservative profits will have higher qualities. Therefore, conservative accounting along with investment growth will reduce profit and accounting profit rate and will produce unregistered reserves. Companies reduce investment and produce higher profit and return rate by setting the reserves free. If investment

change is temporary, its effects on profit and return rate will be temporary as well resulting in a low quality profit.

3. Domestic Evidence:

Banimahd (2006) made a study titled "Explaining and Providing a Model for Measuring Conservatism in Accounting". The goal of that study was first to identify effective components of conservatism in Iran and then to provide a measurable model for conservative accounting standard. Jafari (2008) made a research concerning the relation between conservatism, profit of the coming years and future operating cash flow. The goal of research was to examine if there was any relation between the level of conservatism used in preparing financial statements, operating profit of the coming years and future operating cash flow. The findings showed that there was a significant relation between conservatism in the current year and next year operating profit. This can indicate that personal information of managers about the next year profit affects the conservatism applied by them in the course of financial statements preparation. Shahriari (2008) made a research on investigating the relation between political costs and conservatism (political hypothesis) in Tehran Stock Exchange). In that research he sought to answer the question that if political processes would lead to more conservatism in the performance manner of company's accounting. The findings showed that conservatism would decrease as the size of company increased. It also showed that there was a direct relation between competition level in public ownership and industry and conservatism. No significant relation was found between efficient taxation rate and risk and conservatism. The third and sixth hypotheses show that there is an inverse relation between investment intensity and ownership centralization and conservatism.

4. Foreign Background:

Basso (1997) investigated the relation between earnings and stock yield through regression to estimate conservatism index. He found that stock yield had a higher correlation with earnings in the companies with a negative stock yield than in companies with a positive one. He also found that conservatism had increased during the periods in which legal claims had increased in the US.

Biour and Rayan (2000) investigated the relation between conservatism standard, the costs of depreciation, research and development and publicity and balance value decrease reserve by using LIFO method. They found that descending-based depreciation cost, research and development and

publicity costs had a negative and inverse effect on conservatism, but balance value decrease reserve index had a positive effect under LIFO method. They explained that LIFO reserves were higher during 1981-1993, i.e., when the companies were growing and the markets were not profitable (Nikoumaram; 2008).

In a study made by Lafond and Wats (2006) titled "Information Role of Conservatism", they stated that managers had some motivations to overestimate the profit. On the other hand, uninformed purchasers faced the problem of incorrect selection, e.g., decrease of proposed price for each share. Therefore, the goal of research is to investigate information asymmetry between managers and investors. Conservatism measurement models proposed by Penman and Zjang (2002) and Gioli and Heen (2000) were used for testing the hypothesis. The results showed that analysts included conservatism in their anticipations and therefore their anticipations included conservatism-related systematic error as well. They showed conservatism measurement tools in operating assets to a lower price for both groups with positive and negative growths. Moreover, analysts' anticipation error is not the reason of incorrect pricing in stock market. Analysts' anticipation error in abnormal return regression does not make considerable the decrease of coefficients and T-value. Therefore, conservatism is not the only reason of incorrect pricing in the stock market.

The obtained results show that conservatism reduces managers' motivation to alter accounting figures and overestimate financial performance. Therefore, the companies that apply a higher level of conservatism will face less asymmetric information between managers and investors. This will increase the values of owner's equity and company. Of course, the viewpoint that conservatism is a useful index for decreasing asymmetrical information between managers and investors is in contradiction with the viewpoint of US Standards of Financial Accounting that indicates conservatism will lead to asymmetrical information.

5. Research Method: Hypotheses

This research tested the five following hypotheses to determine their accuracy.

- 1) There is a significant relation between accounting conservatism in receivable accounts and next period operating cash flow.
- 2) There is a significant relation between accounting conservatism in payable accounts and next period operating cash flow.

Variables

Independent variables: Independent variables in this research include conservatism in different accounts of accrual items including:

1. Conservatism index in the accounts receivable

2. Conservatism index in the accounts payable
 Dependent variable: In this research, next year operating cash flow is considered as dependent variable. Research hypotheses are tested using SPSS software. Spatial domain of the research includes the companies listed in the stock exchange. Time period of this research includes 2002 to 2011. In this research, we calculate conservatism index for 10 consecutive years from 2002 to 2011. We used Gioli and Hin Model to calculate the conservatism index in any of the aforesaid accounts.

Conservatism index for accrual items related to current assets = $(-1) \times [(total\ assets\ at\ the\ beginning\ of\ the\ period) / (accrual\ items\ at\ the\ beginning\ of\ the\ period - accrual\ items\ at\ the\ end\ of\ the\ period)]$

Conservatism index for accrual items related to current debts = $[(total\ assets\ at\ the\ beginning\ of\ the$

period) / (accrual items at the beginning of the period - accrual items at the end of the period)]

The models used to test the research hypotheses include the followings:

$$Y_t = \beta_0 + \beta_1 X1_t + \varepsilon$$

$$Y_t = \beta_0 + \beta_1 X2_t + \varepsilon_t$$

$$Y_t = \beta_0 + \beta_1 X1_t + \beta_1 X2_t + \varepsilon_t$$

inn a 2-variable regression model as follows:

$$Y_t = \beta_0 + \beta_1 X_t + \varepsilon_t$$

Line coefficients significance tests include

$$\begin{cases} H_0 : \beta_0 = 0 \\ H_1 : \beta_0 \neq 0 \end{cases} \text{ and } \begin{cases} H_0 : \beta_1 = 0 \\ H_1 : \beta_1 \neq 0 \end{cases} \text{ whose accuracy}$$

is tested by the following statistics:

$$T = \frac{\hat{\beta}_0}{SE(\hat{\beta}_0)} \sim t_{1,1-\alpha/2}, T = \frac{\hat{\beta}_1}{SE(\hat{\beta}_1)} \sim t_{1,1-\alpha/2}$$

6. Results:

Probability level of statistical zero hypothesis indicating lack of any relation between dependent and independent variables is () which is equal to 0.580 and is greater than 0.05. Therefore, this statistical hypothesis is not rejected with 95% confidence. As a result, no significant relation is found between the two variables and in this way, the first hypothesis is not confirmed.

Correlation coefficient between independent variable of accounting conservatism in payable

accounts and next period operating cash flow is - 0.102 and probability level of its significance test is () which is equal to 0.018 and is smaller than 0.05. Therefore, an inverse and significant relation is confirmed with 95% confidence. The diffusion diagram also indicates the type of relation between the two variables.

$$Y_t = 0/149 - 0/071 X1_t - 0/139 X2_t$$

The results of the synchronous model for testing the hypotheses are summarized in table 1.

Table 1. Summarized results of modeling and performed tests for research hypotheses using multiple synchronous model

Test result	Type of relation	independent variable probability level	independent variable coefficient	Correlation coefficient	Research hypotheses
Rejected	Inverse	0.243	-0.071	-0.024	No. 1
Confirmed	Inverse	0.47	-0.139	-0.102	No. 2

Correlations coefficient between all variables are presented in table 4.12. As it can be seen, the highest correlation between independent variables and dependent variable of future operating cash flows belongs to conservatism index in

receivable accounts which is - 0.24. This means that one unit increase in the conservatism index of receivable accounts will result in 0.24 decrease of the dependent variable.

Table 2. Correlation coefficient between all variables of the research

Next year operating cash flow	1	-0.24	-0.102	-0.003	0.063	0.103
Conservatism in the accounts receivable	-0.24	1	-0.047	0.064	0.048	0.076
conservatism in the accounts payable	-0.102	-0.047	1	-0.130	0.005	-0.219

Summary of the Results

The results of some of the researches show that personal information of managers about the next year operating cash flow affects the conservatism applied in calculating the current profit (Abedi; Mehdi, 2006). The results of this research indicates that considering the payment of current year profit in the next year and preparation of financial statements of current year in the first quarter of the next year, managers will have some information about the next

year cash flows and will therefore be able to apply conservatism in calculating the profit of the current year. This means increased or decreased conservatism in the financial statements of current year based on the confidential information gained by managers about the next year cash flows.

Summary of the results including the performed statistical tests, statistical test result and interpretation of results are presented in table 3.

Table 3. Summary of the results of hypotheses tests and interpretation of results

Interpretation of results	Statistical test result	Statistical test	Research hypotheses
The hypothesis indicating a significance relation between accounting conservatism in receivable accounts and next period operating cash flow is not confirmed.	Acceptance of H0	Pierson correlation coefficient – linear regression	1. There is a significant relation between accounting conservatism in receivable accounts and next period operating cash flow.
The hypothesis indicating a significance relation between accounting conservatism in payable accounts and next period operating cash flow is confirmed.	Rejection of H0	Pierson correlation coefficient – linear regression	2. There is a significant relation between accounting conservatism in payable accounts and next period operating cash flow.

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