Relation between adverse risk and profit increase rate

Hamid Reza Ranjar Jamalabadi¹, Mohsen Rezaee Shoroki² (corresponding author), Jalil Jalili³, Mohammad Javad Tohraci Nasrabi⁴

¹Department of Accounting, Yazd Shahid Sadoughi University of Medical Sciences, Yazd, Iran.
²Faculty member of Emam Javad university college, Yazd, Iran.
³Department of Accounting, Yazd Shahid Sadoughi University of Medical Sciences, Yazd, Iran.
⁴Department of financial Management, Science and Research Branch, Islamic Azad University, Yazd, Iran.

Abstract: The manager should compare current personal interests with flexibility obtained by keeping cash fund reserves. In addition, the profit-seeking managers ought to measure the probability of increasing interests’ ratio to expenditure coming from keeping more cash fund. Conservativeness in the field of accountancy has been criticized in many cases while other experts have upheld it. In the current study it is tried to scrutinizing the continuity of the profit growth and conservativeness in the field of accountancy. The project includes all companies listed in Tehran Stock Exchange except the investment companies, banks and insurance companies, which have the needed qualifications for the research. The sample includes 102 companies, selected by “omitting the systematic” method in 2008-2012. The method is multivariate regression. The research results shows the negative relation of continuity of the profit growth and conservativeness, which means the increase of conservativeness decreases the continuity of the profit growth.

Keywords: increase, profit growth, adverse risk, cash

Introduction

As a whole, the main goal of managers of company is to increase their company value. Related to this issue, the accrual payable management found that they can be effective in this issue. Many of the current assets management models including in the financial management literature propose that book profit increase is the main goal of funding that this model, book profit increase, must be related to the other goals (e.g. the company value increase); the solution for increasing company value is along with the uncertainty risk. The increase in accrual payable in a company causes the increase in circulating capital and also the increase in keeping and managing accrual payable, that these costs decrease company value. But a correct policy in portfolio management of accrual payable can increase company value. The timeliness is one of the peripheral aspects of relatedness and because relatedness is one of the discussing issue of accounting and it means the effectiveness of information in making decision. Conservativeness has a long history in the field of accountancy; Accountants try to use it anytime dealing with an ambiguous situation. So in the field of accountancy the cases with the lower optimism are introduced as conservativeness. Basu (1997) argued that the profits have more intense reaction into the bad news while the curve of the graph has more volatility. The managers are obliged to inform the investors, fund holders and beneficiary groups by on time and reliable information and make them familiar with the system of using economical resources and the results of project in the trade unit while helping them to have logical judgment and decision making. The quality of profit is not an explicit and visible concept which has several meanings in researches. Karimi et al (1389) said, managers try to identify the profits and hinder the losses regarding to the stimulants. Conservativeness is a kind of limitation which ruins the ability and tendency of doing the opportunistic manner. In the field of accounting conservativeness is defined as “conservative reaction against uncertainty” in order to supporting the investors and fund holders. One of the main advantages of observing accounting conservativeness for the fund receiver is the decrease in the rate of loan’s lot. The conservative reports makes creditors able to receive timely information about the improper financial act of the company and decrease the risk of receiving the principal and interest of granted loans. Basu (1997) conservativeness means the needed different acceptance for realizing the revenues and costs, which leads to the low appearance of profit and properties. It must be said that the good news have long term effect on the profit while the bad ones have a sudden transitory effect on it. The managers are obliged to inform the investors, fund
holders and beneficiary groups by on time and reliable information and make them familiar with the system of using economical resources and the results of project in the trade unit while helping them to have logical judgment and decision making. If the information related to the profit is timely the expected revenue will be real. So the manger should have enough information about accounting and evaluating timely conservativeness.

**The importance of the research**

The board of directors needs respective information in order to supervise the managers. The conservative financial reporter system is one of the most important resources for obtaining such information. All the companies are trying to find methods of increasing profit and achieving the maximum ideals. The company’s main goal is increasing the investors’ property, with a glance to the main goal of the company it could be found out that scrutinizing the characteristics of the company and its effect on accounting profit has a great importance because by using them the managers could determine its effect and achieve their main purpose. In the recent study it is tried to examine the effect of conservativeness on the stability of accounting profit.

The main goal of the research is scrutinizing the effect of conservativeness on the stability of accounting profit growth, while the related elements are going to be examined.

**The concept of conservativeness**

Conservativeness could be kind of signaling for the managers to represent personal information. The managers, as the responsible of providing financial records with a complete knowledge about the company’ condition and the users of financial records potentially try to show the favorable picture of the business unit. The accounting standards offset the managers’ optimism by means of conservativeness and with the aim of protecting beneficiary groups and representing honest image of the company.

**Uncertainty in conservativeness and risk**

One the principles representing informative role and benefit of conservativeness for the users of financial information is its effect on decrease of opponents of dividing the benefit between the investors and bondholders and also decreasing financial costs. Adhering to the conservativeness tracks and increasing it leads to the decrease of the managers’ tendency to borrowing and also the decrease of financial costs. In the process of contracting the fund maker is confronting with the risk of missing the main asset so, he would adopt any mechanisms that reduce the risk and indeed conservativeness is nothing but the same mechanisms.

Conservativeness and being on time are the two traits of net profit. Conservativeness could be considered as the result of asymmetry in gain and loss situation.

The board of financial accounting standards in the manifest of accounting concepts No. 2 argued about conservativeness and its meaning while define it as:” a conservative reaction to become sure about the suitability of considering ambiguity and risks of trade condition.” The definition considers the ambiguity and risk as important elements in defining conservativeness. The manifest says if there is no ambiguity there would be no need to conservativeness and the more ambiguity and risk you have the more conservativeness you need. Conservativeness decreases managers’ stimulant and ability of changing accounting information so; it can finally decrease the costs of information asymmetry. Wats in expressing an issue to Accountants defines Conservativeness:” do not forecast a profit but, antedate all losses”. Basu interpret the proverb as:”the accounting tendency to the higher level of commitment in accepting and identifying good news or profit in contrast to the amount of needed verifying for identifying bad news or loss”.

**The effects of conservativeness**

For example, a conservative financial reporting by a company could be the sign of more ambiguity and risk and finally the more conservativeness which is obliged in the related standards or shows that the company has selected conservative accounting procedures. In reality the boat elements could be important while their comparative importance is different. So the companies with the aim of preparing conservative financial report may not show an important level of conservativeness if the level of ambiguity is low. In contrast, the companies with the bold financial reporting procedure show high level of conservativeness if the level of ambiguity is high.

**Levels of conservativeness**

Pik et al (2007) stated the companies with the higher level of conservativeness in contrast to the companies with the lower level of it report lower revenue due to their insist on more than usual conservativeness. Conservativeness is considered as the element of tribulation in trade procedure and identifying the revenue so it is known as investors and fund makers’ benefit counterpart. Khan et al (2009) argued the changing of situation makes the reasons different and changes request for conservativeness in different companies.

**The stability of the rate of profit growth**

The higher the level the more financial elasticity the company could have. The company prevents signaling the market about its investment programs by financial securing its interior resources, while it doesn’t have long term procedures of securing by means of capital market.
Research background

Michalski (2007) said that, in other words, net term between debt payment and cash fund receipts is from demand receipt place. One of the other parts of circulating capital management is the period of demand receipts. As a whole, the main goal of managers of company is to increase their company value. Related to this issue, the accrual payable management found that they can be effective in this issue. Many of the current assets management models including in the financial management literature propose that book profit increase is the main goal of funding that this model, book profit increase, must be related to the other goals (e.g. the company value increase); the solution for increasing company value is along with the uncertainty risk. The increase in accrual payable in a company causes the increase in circulating capital and also the increase in keeping and managing accrual payable, that these costs decrease company value. But a correct policy in portfolio management of accrual payable can increase company value. If the cash fund transformation cycle of a company be longer than related industry, it can have two reasons: maybe the period of cash fund transformation for produced goods inventory is more than other active companies so it can be concluded that the company spend more budget comparing to other companies in order to keep the goods in stockroom (including storing costs and opportunity costs) or maybe the period of demands receipts in company with comparison with other industrial ones is longer, so it can be concluded that the demand receipt system of company does not operate correctly or basically the credit policy of company is bolder than the others, that in both cases, it increases the company risk higher than the other active ones in this industry.

Basu et al (2001) scrutinized accounting conservation and the quarter profit during (1991-1998) and (1992-1998) in France. The foundlings showed the accountants’ legal commitments makes the profit of fourth quarter more conservative than the last quarter period, the important losses, negative unusual items and positive special items are also bigger in the fourth quarter period while the effect of bad news is more timely in the fourth quarter period in contrast with the last quarter period.

Lee Huang et al (2001) scrutinized the differences between the conservation of eight big and small accounting company in California and found that, 1- because of being more motive to gain revenue the big accounting companies are more conservative than the smaller ones, 2-the report of bad news is more timely than the good news, 3-in order to measure conservativeness the annual profit is separated from the stuck revenue and, 4-in the bad news where it is the sign of negative unexpected revenue, the annual profit is more timely than the good news which are the sign of positive unexpected revenue.

Taylor et. al² (2003) during the 1993-2000 scrutinized the issue to know whether the non accounting services and profit conservativeness damage the independency of the accountant or not? They used regression method for the analysis. They also scrutinized the non accounting services by the accountants and the range in which the bad news timely affect on profit. The result was if the independency of the accountant decreases it is expected that the conservativeness of the profit will decrease too and it doesn’t seems that the legislator interfere in limitation of non accounting services increase the independency of the accountant although it seems to be.

Francis et al³ (2003) scrutinized the effect of seven elements, including, the quality of accruals, stability of profit, the capability of forecasting, steadiness, the relation of stuck and profit, being timely and conservativeness of profit, on the cost of regular stuck fund in 1995-2001 for 85 companies while using sectional regression to analyze the data. The results showed that the companies with lower quality had higher cost of regular stuck fund in contrast to the companies with higher quality.

Dan Bar et al⁴ (2004) examined the relation between conservativeness and the increase of profit management revenue in 1997-2003. They studied the sectional changes conservativeness of present and past time and concluded that there is a negative relation between conditional conservativeness of present time and profit management while there is a positive relation between unconditional conservativeness of past time and profit management.

Bal et al⁵ (2005) examined the effect of being timely and conservativeness on dept and capital market. In the study they tried to use simple testing of related value and the final cost of contract. They used data from 22 countries while using regression method in analyzing the data finally concluded there is a positive relation between being timely and the capital market. They also found that there is a positive relation between conservativeness and debt. They concluded that the loss will be recognized more timely in asymmetric conditional conservativeness.

Lee et al (2010) scrutinized the role of conservativeness in company’s decision making during 1996-2007 by use of panel method for data analysis. They addressed the issue of whether the conservatism of financial reporting and financial decisions related to financial flexibility?

They finally concluded if conservativeness being under the supervision of capital suppliers they will have more tendency for financial development and increasing the capital. Nevertheless as
conservativeness leads to the hiding of net profit and weaker appearance of the company, there would be less probability for accessing the capital. They found that the more conservative companies have less elasticity in management of their cash flow. They are sensitive about financial limitations and payment policy in their decision makings for paying the debt and issuance of the capital.

Hitam (2010) scrutinized the relation between the conversion cycle of cash and company profitability in 1990-2004. His final sample included 5802 companies. He used panel method for data analysis. He concluded: the shortness of conversion cycle of cash increases the company profitability but any time company face with the shortage of capital the shortness of conversion cycle of cash decrease the company profitability and damage the company activities and leads the access to the qualitative level of supply, receivable and payable accounts, the cost of transforming the supply, the cost of supply opportunity and receivable and payable accounts to the minimum which leads to the prolong of optimized conversion cycle of cash.

**Research hypothesis**

Yan et al (2006) scrutinized the procedure of conservative changes as the characteristic of net profit and the effect of company size and accounting institute size on the elements. They used multivariate and univariate regression for data analysis and finally concluded in general the net profits of companies are conservative but during the time it has become more timely and conservative. The two elements, company size and accounting institute size has also no effect on the studied characteristic of net profit so the net profit of the companies accounted by the accounting organization are not more conservative in contrast to the net profit of the companies accounted by the accounting institutes which are accepted by the stock market.

**Methodology**

The research methodology form the aim point of view is executive, from the implementation strategy point of view is descriptive and from point of view of scrutinizing the relation between the variants is correlated while the researcher is trying to define the expansion, distribution and interactions between the variants. In the recent study the panel regression was used for data analysis and the current formulations developed while the univariate regression was used in order to analyze the research hypothesis.

The definition of variants and calculation procedure of them in the model.

\[ ni_it = \beta_0 + \beta_1 RD + \beta_2 R_d + \beta_3 RD + \epsilon_{it} \]

**Population and sample**

The population consists of all members, whether real or imagined that the findings are generalized to. According to the definition the population of the recent study includes all the companies listed in...
Tehran Stock Exchange except the investment companies, banks and insurance companies.

The study population: all the companies listed in Tehran Stock Exchange from early 1385 until the end of 1389 (comprising 450 companies).

Because of the limitations considered for the population only 90 companies remained in the study and selected as the sample. It must be said that the sampling method was elimination method.

The sample was selected by taking the four elements in mind:
1- The company’s fiscal year ends in Esf and every year.
2- During 1385-1389 the companies do not change its fiscal year.
3- The company still is in the Tehran stock exchange list before the end of the year 1384.
4- The studied companies still are the member of the stock exchange until the end of the year 1389.

Research findings

There is a meaningful relation between conservativeness and Constant growth rate of profit.

The hypothesis is statistically defined as:

- $H_0$: There isn’t any meaningful relation between the Constant growth rate of profit and conservativeness.
- $H_1$: There is a meaningful relation between the Constant growth rate of profit and conservativeness.

The results of scrutinizing the regression tables corresponded the hypothesis have been presented in the table 2-4.

The examination of the first hypothesis using Basu model.

Assumption results in the companies with high and low Constant growth rate of profit.

<table>
<thead>
<tr>
<th>Companies with high Constant growth rate of profit</th>
<th>Companies with low Constant growth rate of profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination period</td>
<td></td>
</tr>
<tr>
<td>$\text{NI}<em>it=\beta_0+\beta_1RD_it+\beta_2R_it+\beta_3R_dRD_it+\epsilon</em>{it}$</td>
<td></td>
</tr>
<tr>
<td>Cross-section fixed (dummy variables)</td>
<td></td>
</tr>
<tr>
<td>coefficient of determination</td>
<td></td>
</tr>
<tr>
<td>0.814</td>
<td>0.895</td>
</tr>
<tr>
<td>Adjusted coefficient of determination</td>
<td></td>
</tr>
<tr>
<td>0.764</td>
<td>0.867</td>
</tr>
<tr>
<td>F</td>
<td></td>
</tr>
<tr>
<td>166.48</td>
<td>32.235</td>
</tr>
<tr>
<td>Probability (prob)</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Camera test - Watson</td>
<td></td>
</tr>
<tr>
<td>1.57</td>
<td>1.957</td>
</tr>
<tr>
<td>Explanatory variant</td>
<td></td>
</tr>
<tr>
<td>coefficient</td>
<td>T test</td>
</tr>
<tr>
<td>R</td>
<td>3.42-</td>
</tr>
<tr>
<td>RDR</td>
<td>6.33-</td>
</tr>
<tr>
<td>DR</td>
<td>5.73-</td>
</tr>
<tr>
<td>Intercept</td>
<td>57.4</td>
</tr>
</tbody>
</table>

Assumption results in the companies with high and low Constant growth rate of profit.

<table>
<thead>
<tr>
<th>Variant</th>
<th>Z test</th>
<th>Probability (p)</th>
<th>Meaningfulness level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant growth rate of profit (sg)</td>
<td>24.12</td>
<td>0</td>
<td>meaningful</td>
</tr>
</tbody>
</table>

According to the F test provided in the two tables and the meaningfulness level the corresponded (prob) examined using regression model in both companies with high Constant growth rate of profit and the ones with low Constant growth rate of profit is meaningful. The Watson camera test also shows non linearity between the wrong terms. So there is a linear relation between the dependant and independent variants. The models’ adjusted coefficient of determination is 0.76 and 0.86 respectively; it means that in the companies with high Constant growth rate of profit 76% of the changes in the net profit and in the companies with
low Constant growth rate of profit 86% of the changes in the net profit could be forecasted by the aforesaid model. As it was discussed in chapter 3, in the scrutinizing the application of conservation in the companies the attention must be pay to the RDR coefficient in the regression model, if it is meaningful it could be said that conservation is applied in the companies.

According to the results provided in the table the RDR coefficient is meaningful that in the companies with low Constant growth rate of profit, while in the companies with high Constant growth rate of profit the said coefficient is meaningless. It means the companies with low Constant growth rate of profit apply more conservation and as a result the Constant growth rate of profit has a inverse meaningful relation while the results of Z test performed to examine R² differentiation prove the meaningfulness of the differentiation.

The probable reason:

The increase of Constant growth rate of profit leads to the decrease of risk, while the decrease of risk leads to the less application of conservation in the companies.

Results

The first subsidiary hypothesis about the effect of Constant growth rate of profit on conservativeness was discussed.

The Results indicate a significant inverse relationship between the rate of growth was steady earnings conservatism.

The probable reason can be: The increase of Constant growth rate of profit leads to the decrease of risk, while the decrease of risk leads to the less application of conservation in the companies.

Research proposal

Recommendations based on findings

1- As the conservativeness is the indicator of transparency and it is considered as a qualitative characteristic by the users and consumers and the profit transparency affects users decision making in investment and according to the research results which indicated that the Constant growth rate of profit has an effect on the conservation; it is recommended that the investors pay attention to the elements while making economical decisions.

2- As applying conservation is a procedure leads to the continuity of the company activities and also according to the relation between conservativeness and cash flow; it is recommended that the investors pay attention to the cash flow while making economical decisions.

Recommendations for the future researches

1- It is recommended that the companies listed in the stock market classified according to their longevity and the discussed hypothesis tested in the said field.

2- As there are several elements affecting qualitative characteristics of accounting profit, it is recommended to take other elements such as leverage ratio, debt and productivity in mind while examining each one’s effect and the simultaneous effect of all elements on the qualitative characteristics of accounting profit.

3- Scrutinizing the effect of management reporting behavior and on conservation and being timely is recommended.

4- Scrutinizing the relation between conservation and being timely with grow opportunity, type of the companies, informational risks and contracts productivity is also recommended.

5- Scrutinizing the relation between conservation and being timely with the companies’ bankruptcy.

6- Scrutinizing the relation between conservativeness and timeliness of the net profit with corporate governance.

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