

Review of the Relationship between Conservatism and Cash Flows Arising from the Financing Activities

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ABSTRACT: Financing methods are considered as one of the main fields of decision-makings of corporate managers in order to increase shareholder wealth. Continued growth of the companies' activities requires funds that these resources provision is often limited. Conservatism is a tool that can lead an entity to become more efficiently organized, and it can cause signed contracts around it. Conservatism leads to timely recognition of losses and reduces the likelihood of bankruptcy of the companies and their collapse (Moradzadeh far,2011). Conservatism can help loan lenders to reduce the amount of credit of a loan borrower. The purpose of this study is to investigate the relationship between the cash flows arising from financing activities and conservatism. The statistical sample of the research consisted of 70 companies during the years 2006 to 2009. Our research findings indicate that there is a significant relationship between conservatism and funds financed through the shares circulation as well as there is a significant relationship and an inverse correlation between conservatism and funds financed through debts and receiving loans.

Keywords: Conservatism, finance, debt, share circulation and equity.

INTRODUCTION

The main goal which management should focus on while selecting the financing method is to increase shareholder wealth. Namely, with considering the cost of each different financing resources and its affect on the efficiency and risk of the company, they select the resources which minimize the financing costs. Appropriate mix of financing sources is associated with the features such as low cost of capital and higher rate of return. Bank loans and capital increase are among the most applied out-organizational resources for financing in the companies active in Tehran Stock Exchange and on the other hand, the reaction of the share market in relation to the basic information record is manifested in the changes of prices and shares efficiency (Mollahnazari, 2009). Conservatism has several advantages, the most important of them are efficient contracts, fewer lawsuits, less or deferring the taxes, tend to neutralize managers bias, political costs reduction, competitive pressures and threats reduction and increase of financial information (Pourheydari, 2011). The higher the corporate debts, the less the firms tend to use conservative methods. As a result, it is expected that corporate managers in order to reduce the likelihood of rejection of loan applications and avoid imposing higher costs, less conservatism is applied in their financial statements (Hassas Yeganeh, 2010).

Theoretical principles and research background:

Adequate financial resources and correct decision-making ability is considered the key factor in the success of the company. The main goal to which management should pay attention while selection the financing method, is to increase shareholder wealth (Mollahnazari,2009). Financial resources are divided into two internal and external groups. Internal sources include such as retained earnings, depreciation reserves, and contingency and legal reserves, and external sources include borrowings loans from banks, bonds and stocks. External funding is very important concerning the effects on the company's financial risk control. Long-term loans and equity are among the

most applied external sources of foreign companies (Jafari Samimi, 2004). Based on the theoretical foundations of accounting, conservatism leads to corporate profits reduction and increases in corporate losses. This indicates that the managers of losing companies, do not want to manipulate its loss into a profit, or they do not have the necessary tools to turn losses into profits. Therefore, conservatism is considered as an effective mechanism for reducing conflicts between managers and other conservative groups in making profits (Bani Mohammed, 2009).

Common framework for the analysis of various methods of financing are usually based on flexible, risk, profit, and scheduling factors. Using a specific method of financing currently may restrict the future useable financing methods. (Moradzadeh far, 2011). For example, using financial facilities at present can incur some restrictions on a profitable unit from further re-borrowing in the next year and can force it to use share circulation method in order to meet the required financing. Method Publication Shares About Use The Shows. Zimmerman, (1983) suggests that the larger firms are applying more conservatism due to more political sensitivities. Conservatism approaches has its benefits and costs to a business unit. Entities adopt their own suitable approach using benefits and cost principle (Pourheydari, 2011).

Conservatism is a criterion for selecting the principles and procedures of accounting in terms of ambiguity and uncertainty. When faced with uncertainty, the methods and procedures should be chosen and applied that eventually lead to the lowest amount possible for the retained earnings. In fact, in conditions of uncertainty and on the crossroads, income and assets must be recognized later on the one hand and on the other hand charges and liabilities must be recognized earlier. This conservative methods choice and application is facilitated through the accrual accounting. For example, detection of the loss of inventory value is effective only on accruals and will not affect the cash flows. Gioli and Hine presented a method to measure conservatism using the accrual method in 2000. According to this method, the continuous presence of negative operating accruals over a long period is considered as a measure of conservatism in the company. That is, the more and negative is the mean operating accruals during the relevant period, the more will be conservatism. However, the rate of accumulation of net operating accruals is a negative indicator of the degree of conservatism over time. (Moradzadeh far, 2011)

In the Conceptual Statement number (2) of the American Financial Accounting Standards Board, conservatism is defined as: "a prudent response to uncertainty and ambiguity in order to make sure that the risks associated with it are sufficiently considered". Some scholars acknowledge the conservatism useful to the financial statements users and analysts and designate informational role for it. Shabahang, (2008) argues the conservative as this: "From viewpoint of financial statement preparers, conservatism is an effort to choose a method of accepted accounting procedures that will result to one of the followings: slower recognition of sales revenue, faster recognition of costs, undervaluation of the assets, and overvaluation of debts.

Miller and Modigliani, (1958) suggest that the favorable effect of alternation of debt with lower financing rates in the financial structure of the company will be compensated with the common stock price of a company; in other words, due to the increase of percentage of financing through debt, shareholders tolerate higher financial risk and with increasing of the financial risk the expected rate of return for shareholders also increases. Companies preferably use borrowing loans from various sources of finance since more usage from the borrowings will increase the company's value. Optimistic view of the managers and owners to the company will be probably reflected in the financial statements and conservatism through requirement to the higher profit proof capability in relation to the loss will lead to reduction of managers optimism while preparing the financial statements.

Theoretical hierarchy of financing options

This theory states that companies in their required financing follow a certain hierarchy. Formation of this hierarchy is the result or consequence of information asymmetry. According to this theory, in case there is information asymmetry between the managers and out-organizational investors, managers prefer to finance from internal resources rather than external resources: i.e. initially they finance from the cumulative or reserve profit, then if internal resources do not suffice, then from the external resources of the company, they first resort to the lowest-risk of stock, that is loan borrowing, and if loan borrowing does not suffice and more money is needed, at the end they proceed and publish shares (Mollahnazari, 2009). Watts, (2003) believes that if the company contracts with various groups such as investors and creditors should be adjusted based on accounting numbers, then due to a conflict of interest between managers and groups, corporate managers will try, with their conservative behaviors, to manipulate those numbers to their own favor. However, perhaps this inference could be wrong, because since conservatism is useful for lenders, it would be detrimental to borrowers; in fact, it is not the case and conservatism has informative context to both groups. Therefore, borrowers and lenders should be shared in the interests. Empirical research also demonstrates this issue that conservatism is valuable and useful for both borrower and lender. Some investigators consider conservatism a loss for the preparers and users of the financial statements.

Research Background

Beatty et al. (2006) examined conservatism and its relationship with the conflict of interest between shareholders and creditors. The research results of this study showed that the conflict of interest increase the need to use conservatism in financial reporting. Adhering to conservative practices and increasing conservatism lead managers to tend to reduces to be financed by borrowing and thus reduce financing costs. In the process of signing a debt contract, the lender faces the risk of losing principal capital; hence, it welcomes all mechanisms that can reduce this risk. In fact, conservative is this mechanism.

Pourheydari and Ghafarloo, (2010) in their study entitled "financing and the level changes of accounting conditional conservatism" concluded that the firms that are financed through long-term debts, on the contrary, it does not reduce the level of conditional conservatism either in the financing period or in the period before that. But the firms that are financed through shareholders' equity, as expected, reduce the level of conditional conservatism in financial reporting both in financing period and in the period before that.

Jafari Samimi et al, (2004) examined the relationship between methods of financing and yields and stock prices. The results of this study showed that the impact of shares circulation in relation to the long-term loans on the stock price is higher. The companies that are financed through the issuance of shares are higher compared to the companies' yields that have used a long-term loan.

Mollahnazari et al, (2009) examined the relationship between methods of financing and the success and failure of listed companies in Tehran Stock Exchange. Their research results show that there is a significant relationship between methods of financing and the success and failure of listed companies in Tehran Stock Exchange and also the capital increase has more effects on the companies' success more than bank loans.

Research hypotheses

First hypothesis: there is a relationship between the financing funds financed through shares circulation and conservatism.

Second hypothesis: there is a relationship between the financing fund financed through borrowing and conservatism

How to collect data and research methodology

Data related to research literature and theoretical principals are extracted from the library resources and scientific databases, and the internal and external articles. In this study, in order to collect the variable-related data, the financial statements provided in the Stocks Exchange website (www.rdis.ir) have been used. Data analysis is performed using SPSS software.

Pearson correlation was used to test the research hypotheses, and the research method is of correlation type; the correlation studies include the studies in which the relationship between the different variables is discovered and/or determined by using the correlation coefficient. The correlation analysis is a statistical tool by the degree to which one variable is measured to another variable that is relevant in terms of linearity.

Statistical society, sample and sampling method

The statistical society of this study is the listed companies in Tehran Stock Exchange. The time realm of the study is years from 2006 to 2009. The following criteria have been used for selection of appropriate method:

- It is not among the investment or financial intermediary firms, holdings, banks and leasing.
- In order to ensure comparability, the end of the corporate financial year is (20 March).
- Corporate financial information is available in the understudy period.
- Stock of the companies has been a continuous trade in Tehran Stock Exchange with no more than 1 month trade-off.

After applying the above conditions, finally 70 companies equivalent to 280 year/company were selected to evaluate and test the research hypotheses.

Definition of research variables

Independent variables included financing through share circulation and financing by loan borrowing whose details are extracted from the firm's cash flow statement.

Dependent variable: the dependent variable in this study is conservatism which in this study in order to measure it, the indicators provided by Gioli and Hine, (2000) were used.

Total assets in the period onset \div ((-1) \times operating accruals) = conservatism index

Accruals are calculated from the net income and operating cash flow difference plus depreciation expense. According to Gioli and Hine (2000), the accruals growth can be an index of change in the degree of accounting conservatism during the long-run period of time. In other words, if accruals increase, then conservatism decreases and vice versa, thus the accruals are multiplied by a negative number in order to determine the direction of conservatism. Since sales can be affecting accruals such as changes in accounts receivable and goods inventory, and the profitability index, so the ratio of sales to total assets as a control variable is added to the research variables. To control the inflation factor on the accrual items and the changes in conservatism as well as to have the homogeneous information at the corporate levels with the different sizes as well as to reduce the anisotropy of the variance in the remaining model, the research variables are divided by the total assets(Bani Mohammed,2009).

Research findings:

Variables normality test

Concerning this fact that many parametric tests are made upon their data distribution normality, they are used with this assumption that data distribution in a community follows at a sample level selected from the mentioned society of the normal distribution. Therefore, before addressing the statistical analysis and reviewing the variables, we specify their type of distribution. In this study, in order to check the normality of the variables, the Kolmogrov-Smirnov (K - S) method is used.

Arbitration: if the significance level is less than 0.05, the hypothesis of the significant variables is rejected. And if the significance level is greater than 0.05, the hypothesis of the significant variables is confirmed.

Results of this test for research variables in tables:

Table 1. K - S test results for research variables

Variable	Significant	K-S Statistics
Conservatism	0.193	2. 87
Loan Borrowing	0.310	1. 88
Share circulation	0.112	1.09

Given the significant level for all variables in this study are more than 5%, therefore, the distribution variables are normal.

Research hypothesis tests

The first hypothesis test: there is a relationship between the financing funds financed through loan borrowing and conservatism.

The mentioned hypothesis is expressed as follows:

- H_0 : there is not a significant relationship between the financing funds financed through loan borrowing and conservatism.
- H_1 : there is a significant relationship between the financing funds financed through loan borrowing and conservatism.

In order to review the relationship between the financing funds financed through loan borrowing and conservatism, the Pearson correlation test was used.

The mention correlation test results is shown in Figure 1.

Table 2. Test result of hypothesis 1

Test	Variable	Statistics	Funded finance by loan borrowing
Pearson Correlation	Conser Conservatism	Correlation coefficient	-0.121
		Significance level	0.000
		Number of observations	280

Pearson correlation with the coefficient of -0.121 and the significance level of 0.000 smaller than 0.01 shows that there was a significant inverse relationship between conservatism and funds financed through borrowing loans, and as a result, with 99 percent insurance, it can be claimed that there is a significant relationship between the conservatism and the funds financed through borrowing loans.

The second hypothesis test: there is a significant relationship between conservatism and funds financed through equity (share circulation).

The mentioned hypothesis is expressed as follows:

- H_0 : there is not a significant relationship between the financing funds financed through equity (share circulation) and conservatism.
- H_1 : there is a significant relationship between the financing funds financed through equity (share circulation) and conservatism.

Pearson correlation coefficients test results for the abovementioned hypothesis is shown in Figure 2.

Table 3. Result Test of Hypothesis 2

Test	Variable	Statistics	Funded finance by equity
Pearson	Conser Conservatism	Correlation coefficient	0.093
Correlation		Significance level	0.003
		Number of observations	280

Pearson correlation with the coefficient of 0.093 and the significance level of 0.003 smaller than 0.01 shows that there was a significant relationship between conservatism and funds financed through equity, and as a result, with 99 percent insurance, it can be claimed that there is a significant relationship between the conservatism and the funds financed through equity (share circulation).

CONCLUSION

Conservatism is considered as an important reporting feature that implies a caution application on the recognition and measurement of assets and income. Conservatism is defined as the requirement to have a higher degree of confirmation for recognition of good news like profit against bad news recognition like loss. The research results show that companies that have had more conservatism, financing funds through shares circulation is more. Because these firms require more financial resources; on the other hand, however, the companies that have less conservatism, have to borrow loans to finance their funds.

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