

Research Article

INVESTIGATING THE RELATIONS BETWEEN AGENCY COSTS AND CONDITIONAL CONSERVATISM

*Marjan Azimi¹ and Younes Badavar Nahandi²

¹Department of Accounting, University Lecturer of Mahdie Khoy Vocational

²Department of Accounting, College of Management, Economics & Accounting, Tabriz Branch, Islamic Azad University, Tabriz, IRAN

*Author for Correspondence

ABSTRACT

Today capital companies are made by collective trying of groups such managers, employees, shareholders and creditors. They come together through a variety of formal an informal contracts conclusion in a stock company. In recent years many conflicts between groups and how companies deal with such contradictions have been raised by economists. These are generally referred as agency theory. Indeed, agency theory proves that managers try to maximize profits to hide the bad news about company and report the good news about company, quickly. In the condition that the agency costs are high, there is a risk that conservatism in financial reporting reduces and management phenomena spread. This study investigates the relation between agency costs and conditional accounting conservatism in companies that have agency costs of free cash flow in listed companies for Tehran Stock Exchange. For this purpose, research condition with 92 companies in the period 2006 to 2011 has been selected as an example. The research method is in type of casual and analysis method in the type of combination of multiple regression analysis by using Eviews software. In the present study, the Basu conservatism index is used to measure conditional conservatism (1997) and free cash flow and growth opportunities interaction are used to measure the agency costs. In this study, the agency costs are used as independent variables and conditional conservatism as dependent variable and the ratio of market value to book value, financial leverage and company size as control variable. The result show that there is a negative relation between agency cost and conditional conservatism.

Keywords: *Conditional Conservatism, Agency Costs, Free Cash Flow*

INTRODUCTION

From an economic perspective, by assuming the relational behavior, it is assumed that all of people are seeking to maximize their interests and managers are also no exception. Managers interested in maximizing personal benefits, social welfare and consolidate its position, and they can provide a good picture of financial position of business unit from shareholders and other stakeholders. But in some cases, increasing the manager's wealth is not in line with increasing other groups such as shareholders. This issue shows the lack of siding of manager's benefits and other stakeholders in the business unit. In the analysis of the created value for shareholders, the company's free cash flow is important. By identifying the appropriate growth opportunities, managers can invest the funds in positive direction and thus, they can increase the wealth of their shareholders. According to the theory of conflict benefits between managers and owners, some managers may be forced to invest free cash flow in the projects with negative net present value and they can supply some their personal benefits in short term. Jensen was the first person who analyzed mentioned problem in his famous theory. He considered the costs of free cash flow as costs that are invested in projects with negative net present value. From Jensen perspective, the managers of business unit with low free cash flow and low growth, manages profit to eliminate the less profits and losses arising investment in such projects and they supply their personal benefits in short term. To solve this problem, Jensen notes to indexes such debt index and distribution of free cash flows as dividend that can modify the above equation (Mehrani and Bagheri, 2009).

Managers as a responsible for preparing the financial situation of company and by a greater awareness with respect to users of financial statement show appropriate image of business unit as a favorable unit.

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For example, by considering the costs of a period as an asset, they can reduce costs and increase profits reported in the financial statements. Also, the entity's net assets can be greater than actual reported amount. The overall result is that the image of business unit is considered better than actual situation and the incentives to capital injection and financing resource increases by external people. In such circumstances, accounting principles and procedures by the support of accounting standards setting authorities and with the aim of balancing the manager's optimism, supporting of the stakeholder's right and providing the financial statement, they apply conservatism concept. Conservatism is one of the features of financial reporting that at least from the early twentieth century, have an impressive quality in accounting and financial reporting. Whether the conservative is a desirable attribute for financial statement or not, and this is a historical issue in accounting literature. Conservatism is one of the restrictive accounting principles (convention accounting has been used by accountant for many years and despite of widespread criticism, it always has maintained its place among other accounting principles. So we can consider the conservative survival against the criticism over many years on this fundamental principle. Many researches have provided evidence of conservatism reporting in America, Britain and European countries, on the other hand, due to the conservative approach and policies governing the accounting standards in Iran, the evaluate of advantages and disadvantages of conservatism has a utmost importance. According to above issues, the main purpose of this study is evaluating the effect of cash reserve on conditional conservatism at listed companies in Tehran Stock Exchange.

Theoretical Foundations

Company's development over time was lead to emergence of stratum capitalists which do not have direct participation in companies. And they guided the companies and supervised on it, according to the selection of board members. This new development emerge a new group of professional managers who have little contribution or no contribution in businesses investment. Thus the management of their organization was separated from capital ownership (Shabahang, 1998). The ownership separation from management led to agency theory. Accordingly, managers do not decide as brokers in favor of the shareholders and owners and they may tend to increase personal benefit. And this lead to their investing on projects that have short-term benefits and ignored long-term benefits of shareholders. According to the manager's effort to maximize their profits than shareholders, the mechanism is used for reducing this problem. One of these mechanisms is the use of accounting data. For centuries, the accounting data are used to measuring the performance of managers and company's value. Accounting numbers are used as main variable for rewarding to the managers and compensating their rights and so managers tend to manipulate the profits due to their wealth. Managers act partially to increase their personal interests in the use of accounting standards that are the basis of informing to investors and they interfere in information sending. If there are no restrictions that limit the manager's opportunistic behavior, the accounting numbers contained in financial reports will be prepared and submitted partially. By improving issues such as efficient investment and monitoring facilities on the investment decisions of managers, it is expected that the conservatism helps to the protecting of company's resources and shareholder's wealth against the agency costs from free cash flow.

The Theoretical Relations between Agency Costs and Conditional Accounting Conservatism

Managers as a responsible for preparing financial statements that are fully aware of the financial situation of the company and greater awareness of users of the financial statements, they try potentially to show a favorable business image.

For example, it is possible that they cause in cost reducing and high profit reporting in financial statements by providing the costs of a period as an assets. And it is possible that the entity's net assets may be greater than actual amount. And the overall report of these operations is that the image of business unit appears better than actual condition and the incentives of capital injection and financial resources increase through external individual to company. In such circumstances, accounting principles and procedures by the support of accounting standards setting authority, with the purpose of balancing the managers optimism, protect the stakeholder's right and provide the financial statement, they apply the concept of conservatism.

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With the high agency costs, there is a risk that the conservatism reduces in financial reporting and the profit management phenomenon spread.

This can causes a negative effect on the quality of reports, bet conservative may increase the quality of these reports from management by reducing the negative effects of these efforts and it can clear the financial statement (Khanlaru, 2009). Jensen emphasizes on the importance of control systems by a tendency to deliver the resources of large companies to itself. Many studies argue that conservative accounting is a part of the control system. And this opportunistic behavior of management reduces the company's value. Chawn *et al.*, (1991) demonstrate that conservatism can effectively reduce the benefits of profit management that are conducted by senior managers (Chawn *et al.*, 1991).

Literature

Chawn *et al.*, (1991) found that conservatism can have an effective role on reducing the benefits of cost management that are conducted by senior managers Anwar and Duelman (2007) concluded that conservatism can reduce agency problems associated with managers investment decisions. Also, unlike the standard viewpoints, conservatism is not a desirable feature in financial reporting.

Mataue (2010) investigates the effect of accounting conservatism on manager's investment incentives. The results showed a negative relation between conservatism and company investment and future operating performance for the companies that are faced with financial constraints. This negative correlation between investment and conservatism can be explained by the literature. That the conservatism can cause unhealthy incentives for investment managers and they ignore the acceptance of projects that have positive invest value. Also, the empirical evidence show that the negative correlation between conservatism and manager's investment with high return volatility and short-term incumbency executives (CEO) is obvious and this negative correlation between accounting conservatism and manager's future investment decrease with higher ownership concentration that shows managers ownership reduces agency conflicts. Hyung (2011) investigated the agency costs effects of free cash flow on a conditional accounting conservatism and concluded the following results:

Research Hypothesis

There is a relation between agency costs of free cash flow and conditional accounting conservatism. Based on nature and methods of research, they can be divided into historical, descriptive, correlation or causal (after event) and empirical (experimental) research (Hafez-nia, 2006).

Research methods from three different perspectives are as follows:

Research Methods from Nature and Content Perspective

This study investigates the relation between agency costs of free cash flow and conditional conservatism accounting and this study is the type of content analysis-descriptive. The mentioned method for researches such this study is useful because these studies are designed to explore the relation between different variables. This study has investigated the related data to a particular time that are a combination of time series and sectional series and this study is considered as a practical research because the results obtained in this study can be used in the financial data processing.

Research Method from the Purpose Perspective

This method is a practical study that uses actual data and various statistical methods for hypothesis rejection or acceptance and it is placed in PAT.

The Research Method

This research was conducted within the deductive-inductive reasoning. This means theoretical literature from library research, articles and websites is in the inductive form and data collection to confirm or reject the hypothesis is in deductive form.

Statistical Population and Sample

Due to the spatial domain of study, statistical sample will be selected by taking elimination method and considering the temporal and spatial domain of study.

1. With respect to the data required from the year 2005, companies which have been accepted up to the march 2005 in Tehran Stock Exchange and their name should not be deleted until the end of 2011 from the listed companies.

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2. It should not have trading halts more than six months.
3. To enhance the comparability of studied companies, their financial period should be ended in 29 march and in the study period, they should not have financial changes.
4. It should not be a component of financial intermediation companies (investing, Holding, leasing, banking and insurance) because of their differences in capital structure.
5. Required information should be available.

Methods and Data Collection Tools

In each study, providing factual data regarding to the study's objectives is so important. In this study, for theoretical studying and literature reviewing, the library method is used by using books and scholarly articles and dissertations. Since the variables of this study include many accounting items that are contained in the audited financial statement of companies. The required data are extracted manually from financial statement from manage research sites, development and Islamic studies affiliated with the securities and exchange organization with the www.rdis.ir address, Kdal network, comprehensive information systems with www.codal.ir address, Financial Information Processing center of Iran with the www.fipiran.com address and CDs of securities and Exchange. And seems that has higher reliability than other available sources. And other required information related to Stock Exchange of the company is collected in Exchange database and in software which are in a form of PDF and Excel files.

Variable Measurement

According to Basu (1997), conservatism leads to less sustainability in periods with bad news than good news. He suggests that using more conservative approach causes that loss recognition is done quickly and in current period. While the profit recognition is conducting gradually and over some periods, so, in conservative accounting, bad news influence on profit, quickly but this effect could not be sustained. In contrast, the good news need more time for reflecting in profit, but this reflection in future periods has more stability. By using the following model, Basu found that profit asymmetry in reflecting good and bad news leads to different degrees of stability.

Hypothesis Test

To test the research, the following formula will be used:

$$\begin{aligned} \left(\frac{E}{P}\right)_t = & \alpha_0 + \alpha_1 D_t + \alpha_2 R_t + \alpha_3 D_t R_t + \alpha_4 AGENCY_{t-1} + \alpha_5 D_t AGENCY_{t-1} + \alpha_6 R_t AGENCY_{t-1} \\ & + \alpha_7 D_t R_t AGENCY_{t-1} + \alpha_8 x_{t-1} + \alpha_9 D_t x_{t-1} + \alpha_{10} R_t x_{t-1} + \alpha_{11} D_t R_t x_{t-1} + \alpha_{12} AGENCY_{t-1} x_{t-1} \\ & + \alpha_{13} D_t AGENCY_{t-1} x_{t-1} + \alpha_{14} R_t AGENCY_{t-1} x_{t-1} + \alpha_{15} D_t R_t AGENCY_{t-1} x_{t-1} + \alpha_{16} MB_{i,t} + \alpha_{17} LEV_{i,t} \\ & + \alpha_{18} SIZE_{i,t} + \varepsilon_{i,t} \end{aligned}$$

in above model, α_3 is the conservative intensity and α_7 is the decreasing(increasing) effect of agency costs on conservative intensity and if it be significance, shows the relation between agency costs and conditional accounting conservative

Where

$\frac{E}{P}$: The profit to price rate in each share

D: it is a Dummy variable and is zero if the company's return was positive, otherwise it is 1.

R: Annual stock return of company I in t year.

To calculate the annual return of company's shares, the following indicators are presented:

$$R_{i,t} = \left[P_{i,t} (1 + \alpha + \beta) - (P_{i,t-1} + c\alpha) + DPS_t \right] / (P_{i,t-1} + c\alpha)$$

Where

R: the total return share of the company I in period t

To calculate the annual return of company's shares, the following indicators are presented:

$$R_{i,t} = \left[P_{i,t} (1 + \alpha + \beta) - (P_{i,t-1} + c\alpha) + DPS_t \right] / (P_{i,t-1} + c\alpha)$$

Where

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α :The percent of capital increase from the cash and reveivable
 β :The percent of capital increase from the reserves and profit share
 C: The price of underwritten stock
 $P_{i,t}$: The price of stock company I in the end of t period
 $P_{i,t-1}$: Distribution of stock dividends in The price of stock company I in the beginning of t period

DPS_t : period t

AGENCY :The agency cost index

α :The percent of capital increase from the cash and reveivable

β :The percent of capital increase from the reserves and profit share

C: The price of underwritten stock

$P_{i,t}$: The price of stock company I in the end of t period

$P_{i,t-1}$: The price of stock company I in the beginning of t period

Ducas *et al.*, (2000) represented that the agency costs (AGE_{t-1}) are as a function

in growth opportunities and free cash flows. As a result, companies with low growth opportunities that contains high free cash, and they are classified in companies with high agency costs. In this study, for measuring the agency costs, we first calculate Tobin's Q costs and free cash flow. Growth opportunities have been measured by Tobin's Q ration which is measured as follows:

$$Q = \frac{VOCSILOY + EMVOPSILOY + BVLTLILOY + BVCLILOY}{BVTALLOY}$$

In the above model:

VOCSILOY: the common stock value at the end of year.

EMVOPSILOY: Estimated market shares at the end of the year.

BVLTLILOY: Book value of long-term at the end of year.

BVCLILOY: Book value of current debt at the end of year.

BVTALLOY: Book value of total assets at the end of year (Sajjadi *et al.*, 2010)

Also there is not a preferred stock in Iran and it is given only from bailment aspect.

Free cash flows in this study using the Lehn and Poulsen model

Based on this model, free cash flows are defined as operating profit before depreciation to the fraction of total plus interest expense and dividends. And divided by the total standards assets (Lehn & Pouleson) and the variable calculation are given in the following equation:

$$FCF_{i,t} = (INC_{i,t} - TAX_{i,t} - INTEXP_{i,t} - PSDIV_{i,t} - CSDIV_{i,t}) / ASSET_{i,t}$$

FCF: Free Cash Flows

INC: Operating profit before deducting depreciation expense

TAX: Taxes

INTEXP: Interest Expense

PSDIV: Profit Paid to preferred shareholders

CSDIV: Profit paid to ordinary shareholders

ASSET: The total book value of assets

As mentioned in previous section, there is no preferred stock in Iran and it is important due to its bailment aspect.

The control variables include SIZE, MB, LEV as follows:

SIZE: natural logarithm of the equity market value.

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MB: the ratio of the equity market value to equity book value at the end of fiscal year

LEV: The ratio of total book value of debt to book value of total assets at the end of fiscal year. In the hypothesis, the cash reserve variable is considered as a damper variable to agency cost.

The hypothesis states that there is a relation between agency costs and conditional accounting conservative.

H0: there is relation between agency costs and conditional accounting conservatism of the companies that have agency costs of free cash flow.

H1: there is no relation between agency costs and conditional accounting conservatism of companies that have agency costs of free cash flow.

The table of Hypothesis test results

Prob.	t-statistic	coefficient	Sign	Variable
0/720	-0/358	-0/025	C	constant
0/470	-0/721	-0/021	D	Type of return
0/116	-1/570	-0/031	R	Annual return
0/727	0/348	0/025	D*R	α_3
0/060	1/881	0/048	AGENCY	Agency expense
0/353	-0/928	-0/048	D*AGENCY	α_5
0/268	-1/108	-0/033	R*AGENCY	α_6
0/298	-1/040	-0/160	D*R*AGENCY	α_7
0/981	0/022	0/000	CASH	Cash retrieve
0/961	-0/048	-0/002	D*CASH	α_9
0/252	-1/146	-0/035	R*CASH	α_{10}
0/855	-0/182	-0/021	D*R*CASH	α_{11}
0/249	1/152	0/038	AGENCY*CASH	α_{12}
0/769	-0/292	-0/025	D*AGENCY*CASH	α_{13}
0/339	0/956	7/618	R*AGENCY*CASH	α_{14}
0/325	-0/985	-7/839	D*R*AGENCY*CASH	α_{15}
0/006	-2/742	-0/098	LEV	Financial leverage
0/000	3/398	0/077	MB	The ration of market value tobook value
0/000	4/555	0/021	SIZE	size
1/774	D.W	5/583	F-statistic	
0/202	R ²	0/000	(Prob.) Significance level F	
رد	0/000	5/842	(Chaw test (constant effst)	Panel type
تأيید	0/980	0/000	Huasman test	

According to the test results of multi variable regression that is provided in above table, the results of Chow and Hausman test and a significance level of these tests will be confirmed, the value of Chow statistic is 842/5 and its significance level is 000/0 and also, the Hausman test statistic is 000/0 and its significance level is 980/0. Because the significant level of Chow test is lower than 05/0 and on the other hand, the significant value of Hausman in higher than 05/0, so the random type is random effect. The ratio of regression F-statistic is equal to 5/583 and its significant level is lower than acceptable error level (5%) that this coefficient indicates the significant level of regression model in the 95% confidence level. The value of Watson statistic is 1/774 and because this statistic is between 5/1 and 5/2, and shows there is no correlation between components of model error. The coefficient of determination indicates that the

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independent and control variables in the model, explain 20.2% of the variability. The results of hypothesis test show the coefficient value is equal to $-7/839$ and the t-statistic is $-0/985$ and the significance level of excess cash reserve to conditional accounting conservatism is equal to $0/325$. These coefficients indicate the surplus cash reserve to conditional accounting conservative. So the research hypothesis is not approved. So the coefficients of control variable and their confidence level show that the financial leverage variable has negative effect on the ratio of profit to the price of each share. Also, the variable of the market value to book value and the companies' size have a positive effect on the ratio of profit to price.

Overall Concludes

Due to the high cost of agencies, there is a risk that conservatism reduces in financial reporting and earning management phenomena is spread. The empirical evidence shows that the negative correlation between conservatism and investment management companies with high return volatility and short-term incumbency Executives (CEO) is obvious. The negative correlation between accounting conservatism and future investment management executives with higher ownership concentration decreases, which indicates that ownership managers reduce agency conflicts. The obtained results from this theory show that the agency costs of companies have an inverse relation with the degree of conservatism. The results indicate that agency costs in Iran is not an important factor for determining the quality of financing reporting and high agency costs cannot enforce to company manager to apply more conservative in financial reporting and profit management phenomenon spread.

The results do not match with the results of Chawn *et al.*, research and hyung

Suggestions of Research Results

Due to results, there is a risk that with high agency costs, conservative in financial reporting reduces and the profit management spread, and shareholders should be aware of this issue and in the severity of agency costs, they should increase demand for conservatisms in financial reporting. The result of lack of significant relation between agency costs and conservatism in financial reporting is better than a negative result. But if the relation be positive and significant, it is much better.

So, here we can propose to investors to apply financial conservative reporting as a supervision mechanism and control on performance and limiting the manger's decision. In investment decisions, these companies should make a good attention to conservative in financial reporting and due to the results of this research; we concluded that government cannot have an efficient monitoring in company conservative.

Suggestions for Future Research

- 1- Investigating the relation between accounting conservatism and free cash flow
- 2- Investigating the relation between conservatism and managers performance
- 3- Investigating the relation between conservative on high investment and low investment.

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