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SURVEYING THE IMPACT OF CONDITIONAL AND UNCONDITIONAL CONSERVATISM ON EARNINGS QUALITY OF LISTED FIRMS IN TEHRAN STOCK EXCHANGE

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ABSTRACT

Investors always care particularly about the accounting profits and they consider the high profits as the means for the enhancement of their wealth; while, this kind of attitude is called the inexperienced investment. Because the Firms' managers, by manipulating the accruals, the financial statements and through using the non-mentioned cases in the accounting standards, have made the necessity usage and they have managed the profits easily. Therefore, in order to find an appropriate way to prevent this naïve attitude and make an appropriate decision, the concepts of earnings quality have developed in which the components of accounting profits are regarded; on the other hand, the conservatism in the accounting issues is considered more important. So, by considering the importance of earnings quality and the conservatism, this research studies the impact of conditional and unconditional conservatism on the earnings quality. In order to achieve this purpose, conditional conservatism based on non-operational accruals and unconditional conservatism based on the accruals of total calculation and the earnings quality are measured and calculated through the ratio of operational cash flows to net profits. To test the research hypotheses, the financial information of listed firms in Tehran Stock Exchange is used. So, in this research, 103 firms are selected as the sample among listed firms in Tehran Stock Exchange and their financial information is gathered during 2003-2011. The data are analyzed through the application of multiple linear regression model and integrated (consolidated) data. The research results obtained indicate that there is a positive and

significant relationship between conditional conservatism, unconditional conservatism and the earnings quality of listed firms in Tehran Stock Exchange.

Keywords: Conditional Conservatism, Unconditional Conservatism, Earnings Quality

INTRODUCTION

Conservatism is one of the characteristics of financial reporting in the framework of a limiting principle in the framework of principles and accounting concepts, which has an important role, on the one hand, in limiting the optimistic behavior of managers acting as the information provider andon the other hand, in estimating of the minimum of investors' and creditors ' gains acting as the most important users; the managers have potential motives to show the position of the firm as the preferred and favorable one. And because of the managers' options in presenting the financial reports, they gain the opportunity to do this. Therefore, the presence of monitoring and supervising mechanisms is necessary (vital) to conserve the shareholders' interests. **Givaly and Hanyn (2000)** show that in the previous researches and evidencesuch asthe study of (**Larra** *et al.*, **2010**), the desirable effects of conservatism on financial reporting environment in order to conserve the shareholders' interests and creditors have been indicated. However, based on the belief of **Hotton** *et al.* **(2009)**, managers are able to hide the bad news related to the firm and it seems that the negative information will be stored within a firm. However, there is a limitation for the managers with respect to the amount of bad news they can absorb and they can successfully hide. The reason for this limitation is that if, at certain time, the amount of the bad news gathered reach to a threshold and or a definite and especial limit, after that hiding the news is so costly and it is generally impossible. So, studying this issue is important and so necessary. Because, firstly at such firms, the volume of the bad news is higher compared to other firms; therefore, the manager attempt more in order to hide the bad news, secondly, the necessity of conserving (maintaining) financial resources of firms through the less showing of profits and assets is much more. Fasb, in his studies, believes that the adverse effects of conservatism on the ratio of profitability; but, on the other hand, there is evidence related to the efficiency of conservatism in reducing the profit-seeking motives of managers and supporting the capital providers' interests of joint stocks. Most of these researches such as the researches of **Paek et al. (2007), Gul** *et al.* **(2002), Rezazadeh and Azad (2008)** are supervising the role of conservatism in reducing the agencies' costs and their impact on conserving the creditors' and investors'

interests. Thus, the objective of this research is to complete the theoretical bases of the previous researches and justify the conservative procedures on financial reporting environment and quality of the presented information in financial statements. In sum, the necessity of conducting the present research is to identify the accounting conservatism as a beneficial mechanism infinancial reporting and its impact on generating the margin of safety for the shareholders and creditors in relation to the appropriate application of the firm's resources and its beneficial impact on the earnings quality. It should be pointed out that in the Iranian Accounting Standards; the conservatism is mentioned as the precaution which is one of the qualitative characteristic of the accounting information. This research is to try to examine the relationship between conservatism and earnings quality through considering various criteria of conservatism. The ideal objective of the present research is to help the managers of joint stocks in conducting the appropriate level of conditional or unconditional conservatism that may be demanded by the providers of firms' capital; therefore, the main objective of this research is to study the relationship between conditional conservatism, unconditional conservatism and the earnings quality.

Earnings Quality

The earnings quality is an important criterion for evaluating the financial health of commercial unit **(Bllovary, 2006)** and it is a multi-dimensional concept that has no single meaning for instance **Shipper and Vincent (2003)** regard the earnings quality as a limit that the reported earnings is the indicative of Hicksian Income; since Hicksian Income is not observable, Shipper and Vincent consider three dimensions for evaluating the earnings quality: stability, predictability and earnings fluctuation; these dimensions are consistent with the theoretical framework. The earnings quality may be evaluated by the combination of stability, predictability and fluctuation (**Richardson *et al*., 2004). Teets (2002)** indicates that some people consider the earnings quality as the capability of accounting earnings for expressing the economic events. **Penman (2003)** examines the earnings quality by the relationship between present and future earnings. **Entwistle and Phillips (2003)** regard the earnings quality as the earnings capability for providing the primary objectives of financial reporting; therefore, the earnings, for investors, creditors and all users provide the information with respect to assessing the cash flow of the commercial unit. **Bllovary *et al*. (2005)** regard the earnings quality as the symbol of the reported earnings in expressing the real earnings of the

commercial unit, predictability of the future earnings, stability and lack of variability of the reported earnings. Board of Financial Accounting Standards states that the earnings calculated based on the promissory accounting, compared to cash flows, are more capable of predicting the future cash flows because the accruals are an important key of earnings; they contain information about the future cash flows; therefore, from this perspective, it is concluded that the earnings which have more capabilities in predicting the future cash flows are more qualitative. The earnings quality is the concept related to the earnings management but they do not have the same meaning. The concepts of earnings quality and earnings management have a common characteristic that is none of them have been defined well. Earnings management can affect the earnings quality. According to various definitions of earnings quality, different models have been designed for examining it. Most of these models and definitions are similar but none of them has a perfect view toward the earnings quality **(Bllovary, 2006)**.

The Importance of Evaluating the Earnings Quality

The importance of evaluating the earnings quality can be justified from three perspectives; these perspectives include: the perspective of investors, the perspective of

users of financial statements and the perspective of the standards drafters. From the investors' perspective, the earnings quality suggests how to allocate resources. The low earnings quality due to improper allocation of resources, leads to the reduction of the economic growth; therefore, it is not desirable. From the users' perspective, the reported earnings are commonly used in debt contracts and bonus plans. Thus, making decision, based on the earnings with low quality, causes the transfer of wealth. For instance, if the earnings are applied as an evaluative criterion of the management performance; providing the earnings, more than the supposed ones, leads to granting salaries and excessive benefits to the managers. Moreover, such earnings may hide the financial crisis of the firm and cause the development of improper credits by the creditors. Also, when the drafters of accounting standards seek the feedback of standards in terms of efficiency; the outputs of accounting system including earnings will be noticed. It means, from the perspective of standards drafters, the financial reports and indirect earnings are the representative of the quality of the financial reporting standards **Ismaeili, 2007)**.

The Criteria to Assess the Earnings Quality

Among the criteria to assess the earnings quality, the following ones can be mentioned:

Stability of earnings, the levels of accruals and the earnings are the representative of the concerned economic transactions. Stability of earnings means the repeatability (continuity) of the current earnings. The more stability of earnings means the more capability of the commercial unit to maintain (reserve) the current earnings; therefore, the earnings quality of commercial units is much more. Overall, if the reported earnings help the users to make better decisions, such earnings are regarded more qualified. Some analysts believe that if the ratio of operational cash flows to the net earnings is much more, the earnings quality will be higher.

Thai (2004), in his studies, applies the following cases as the index of earnings quality.

1- The quality of accruals: it is a limit that the accruals adjust and or transfer the identification of the cash flow; therefore, the adjusted accruals measure the performance of the commercial unit better and predict the earnings of the future cash flow.

2- Earnings Stability: it is a limit that the change in the series of earnings causes the investors to reconsider the

future earnings **(Lip, 1987 & Lou, 1989)**.

3- Predictability of Earnings: it is the capability of earnings to predict their future.

4- Income (earnings) Smoothing: it is using the accruals to smooth the earnings.

According to Thai's point of view, the earnings quality is high when:

1- The quality of accruals is high.

2- Earnings stability coefficients are significant.

3- The earnings predictability is high.

4- The incoming (earnings) smoothing is low.

Conservatism

In accounting, the conservatism is the concept which has a long history. **Basu (1997)** believes that during centuries, conservatism has influenced the theory and practice of accounting. The historical records of early fifteen century A.D, about the collaborative and partnership transactions, show that accounting in the medieval Europe has been conservative. The concept of conservatism was developed when the balance sheet was the most important and the only financial statement and the components of the earnings and or other results of performances rarely were presented outside the firms; researches have presented different definitions of

conservatism in accounting. Some of them such as **Paeek *et al*. (2007)** define the conservatism in this way: conservatism means the tendency of accountants to the identification accompanied by the earnings delays and the less evaluation of assets. **Givaly and Hanyn (2000)** define the conservatism as the selection of one accounting approach under the conditions of uncertainty which finally leads to providing less assets and incomes and has the less effects on the rights of shareholders (equity of holders). **Watts (2002)** defines the conservative accounting in this way that the prediction of future earnings should have more verifiable abilities compared to the future losses. **Watts (2003)** defines conservatism through the following statement; predict no earnings but always predict all losses; in our country-Technical Association of Auditing Organization, in the attachment of Iran Accounting Standards, in the section of theoretical concepts of reporting which is the translation of Principles Statement of the UK Accounting Standards Board- recognizes the conservatism with another concept named as precaution and introduces it as the one of the components of qualitative characteristics of reliability (**Mojtahedzadeh, 2001**). The Association, in theoretical concept of financial reporting, describes the precaution through this manner: the precaution is the

application of a degree of care in executing the judgments which is required in order to estimate the ambiguity terms; in the manner that the incomes and assets are more than the supposed ones and the expenses and debts are not less than the supposed ones. Therefore, conservatism can be applied as a moderating factor or a counterweight to prevent too optimistic measurements; as a strong and effective deterrent tool against the risk of presenting earnings and financial condition, the conservatism can use the amount more than the supposed ones. On the other hand, too conservative preparation of financial statements is not desirable because it leads to the non-observance of impartiality and presentation of unrealistic information. Therefore, the concept of conservatism should not be defined and applied in the manner which leads to the presentation of the figures of financial statements to amounts less than the supposed ones. Appropriate and logical application of conservatism in accounting can prevent from the future probable claims of investors and creditors due to the application of too optimistic procedure of accounting.

Generally, conservatism can be classified into three categories as the following:

    a) Behavior Category: pessimism is better than optimism. For instance, based on the accounting guidelines,

probable liabilities (probable losses) are identified under special circumstances. While, these guidelines are not applicable regarding to the probable assets (probable earnings).

b) Time Category: earlier showing of the losses and costs is better that the later showing of them.

c) Value Category: the less showing of earnings and incomes is better than the more showing of them. The more showing of losses and costs is better than the less showing of them. **(Watts, 2003)**.

Based on the discussions presented, the conservatism can be defined in the following statement:

Conservatism is an accounting concept leading to the reduction of reported accumulated earnings through the later identification of incomes and faster identification of costs, low assessing the assets and high assessing of the liabilities (debts).

The Reasons for Existence and Justification of Conservatism

Researchers have provided different interpretations about conservatism. All these interpretations point out that conservatism is beneficial for the users of financial statements. Researchers have proposed justifications for the conservatism in reporting. They can be expressed as the following:

Drawing up the Justifiable Contract for Conservatism

Watts and **Zimmerman (1986)** believe that the drawing up the contract causes the development of agency costs. Seeking an access to the mechanism for the reduction of costs has led to the development of a demand for accounting services as an effective tool in the procedures of contracts of the commercial unit; more contracts of economic units are drawn up with natural and legal entities based on the accounting figures in order to reduce the agency costs. On time verifiability and asymmetry in verifiability of accounting figures are significantly important and demand the application of conservatism.

Income Tax

Ganter *at al*. (1997) suggest the methods of accounting which are influential in income tax. Also, **Fourd and Shiling (2001)** find out that the tax develops this motive that the reported accounting earnings are coordinated with the income tax; while a firm makes profits and the rate of income tax is positive; deferring the identification of earningscan decrease the income of the present value of the tax and report the value of net assets less; therefore, the income tax is considered as a justification for conservatism.

Lawsuits

Watts (1983) proposes the performance of stock exchange as the lawsuits for justifying the conservatism in accounting. **Ki Lag (1984)** finds out that the ratio of lawsuits proposed by the purchasers of securities in the court against the auditors and economic units is more than the lawsuits proposed by the sellers of securities in the court against the mentioned entities; according to the findings, it seems when the costs of lawsuits from the interests of the earnings report and net assets are more that the supposed amount, auditors and managers will have motivation for the less showing of earnings and net assets amount.

Regulatory Requirements, Justifications for Conservatism

The regulatory centers are factors for applying conservatism in financial statements. **Watts (1987)** expresses that in the political process, the loss due to not applying the conservatism in earnings and asset reports is justifiable. This loss is more than the earnings due to the application of conservatism in earnings and asset report; therefore, this motivation arises for the managers of economic units that they report accounting figures conservatively.

Assessing the Criteria of Conservatism

The researchers apply three criteria for measuring conservatism **(Kordestani and Amirbeigi, 2008)**.

1) Net assets criterion
2) Earnings and accruals criterion
3) Relationship between earnings and stock returns criterion

In these criteria, the impact of identifying the asymmetry of conservatism is measured from profits and losses over the reported accounting figures especially the net assets, incomes and accruals.

Conservatism Types

Rayan (2006) presents a definition for conservatism; based on his definition, conservatism is divided into conditional conservatism and unconditional conservatism.

Conditional Conservatism

Conditional conservatism or profit and loss conservatism or predetermined conservatism, is a kind of conservatism which is required through the accounting standards. It means the identification at the loss level in the case of bad and undesirable news (negative stock returns) and the absence of identification of earnings in the case of good and desirable news (positive stock returns); the principle of the minimum of total cost or net value of sale in evaluating the inventories (stocktaking) is a kind of conditional conservatism. This kind of conservatism is called profit and loss conservatism or retrospective conservatism. **(Rayan, 2006. pp. 511-525) Basu (1977)** describes that conservatism is required to

have a higher degree of verification for recognizing good news such asearnings against the recognition of bad news such as loss; this definition describes conservatism in terms of profit and loss indicating the conditional conservatism. This definition based on the studies done by Lava and Saha in the capital market is confirmed. **Basu (1977. pp.37)** also states that the conventional and legal interpretation of conservatism leads to the application of the conditional conservatism.

Unconditional Conservatism

Unconditional conservatism or balance sheet conservatism or prospective conservatism, unlike the conditional conservatism, is not required by the accepted standards of accounting and it is the result of less showing of the supposed book value of net assets through the predetermined procedures of accounting. This type of conservatism is known as the balance sheet conservatism **(Rayan, 2006, 511-525) Felltham and Olsson (1995)** defines the conservatism from the balance sheet viewpoint; based on this viewpoint, in the cases when there is a doubt among choosing two or more methods of reporting; the method should be chosen that has the least desirable effect on the rights of shareholders. **(Felltham and Olsson, 1995, pp. 68)** Also, the legal, tax, etc. interpretations lead to the application of

unconditional conservatism. **Keyang (2007)** expresses that according to this view, the accounting of all the historical paid costs is recommended as a conservative procedure because the positive present net value of investing in accounts is reported less than their fair values.

Literature Review

Ismail and Elbolok (2011), in the article entitled Do Conditional and Unconditional Conservatism Impact Earnings Quality and Stock Prices in Egypt?, examine the impacts of conditional and unconditional conservatism on the earnings quality and stock price in Egypt and they present the new insights in this field. In this regard and in order to achieve the objectives of this research, the econometric approach of time series data related to 30 cases of the biggest firms related to Egypt during 2005-2009 is enjoyed. The results show that: 1) conditional conservatism has had a negative impact on the earnings quality and stock price in Egypt Firms. 2) Unconditional conservatism has had no impact on the earnings quality but it has had a negative relationship with the stock price in this country. The findings of this research help the enhancement of earnings quality and presentation of appropriate financial statements related to the firms of Egypt and this can lead to making more logical decisions by the investors. The unique

feature of this study is to examine the impact of conditional and unconditional conservatism on earnings quality and stock price in Egypt.

Zhu and Xia (2011), in the article entitled Accounting Conservatism and the Pricing of Stock Index: Analysis Based on the Stock Market Correction in China, examine the feedback of market in China during the correction period in this country from the conservative accounting perspective. The authors state in this article that bond market of China like other sections of investments and inter-mediators is gradually growing. They point out that the incomings of accounting are a key factor among the effective factors on the stock prices. Correction in the stock market in this country is an opportunity for the investors to reevaluate the stock prices. In this study, by the application of the data of the available firms in the financial corrections in China; the reactions of these firms confronting with corrections have been examined. It is expressed in this article that there is a sufficient theoretical practice in pricing the stock from the accounting conservatism but the empirical practice is rare. Therefore, firstly, this article provides much evidence for the role of stock pricing from the accounting conservatism especially in the emerging markets. Secondly, the present research considers the accounting conservatism in China with the focus of whether there is conservatism and how different this conservatism is. This article is much more the expansion of research field of conservatism from the pricing view. Thirdly, the previous researches are based on the factors of stock compensation and market feedback in the stock and the correction of non-theoretical analysis. While, this article based on the theory provides market feedback in the correction of the stock. Their results show that the accounting information plays a role in stock pricing of China through the corrections of dividing stock in the Stock Exchange market in China. Also, the evidence indicates that there is a positive relationship between conservatism in accounting and accumulated earnings during one-day, three-day, ten-day, thirty-day course in this country after the correction period. Moreover, the improvement of profitability of the studied firms leads to the development of more severe positive relationship between conservatism and market's feedback in China.

Mohhamadabadi, Mashayekhi and Mirziei (2012), in the article entitled Surveying the Impacts of Conservatism and Structural and Operational Features of Firm on Disclosure Quality, state that in the theoretical accounting bases, there is a great emphasis on having the disclosed

information as the characteristic of reliability. It can be predicted that accounting conservatism as a qualitative sub-feature can play a significant role in the enhancement of reliability and consequently, it can enhance the quality of disclosing information. Regarding this, the present research seeks to collect and examine the available empirical evidence about the impact of accounting conservatism on the disclosure quality. The statistical analysis of data related to 111 listed firms in Tehran Stock Exchange during 2004-2007 shows that simultaneously, by the application of higher degree of conservatism, the qualitative level of disclosure imposed by the firm is also increased. These results obtained in the conditions that the effects of variables related to the structure and performance on the disclosure quality are controlled and examined. Therefore, it can be said that the available convincing empirical evidence, according to the theoretical bases of accounting, expresses the direct impact of conservatism on the disclosure quality and reporting the financial information. So, the present study is to test the hypothesis of the existence of the direct relationship between conservatism and disclosure quality in the financial reporting environment and our country's capital market. With this regard and for the reason that the findings of

research are to be significantly interpretable, the impact of variables related to the structure (size and leverage)and the impact of variables related to the performance (profitability and liquidity levels) have also been studied and controlled. The statistical analysis of data of 444 firms indicates that there is a direct and significant relationship between conservatism and disclosure quality. In other words, the main hypothesis of the research is confirmed through the available empirical findings. On the one hand, the research findings indicate that there is a negative relationship between the variables related to the structure and disclosure quality and on the other hand, they imply there is a direct relationship between the variables associated with the structure and the disclosure quality. With regard to the relationship of the variables related to the performance and disclosure quality, the findings of the present research emphasize on the concepts of signaling theory.

Research Hypotheses

According to the discussed issues in the previous sections, in order to answer the main question of the research which is discovering the relationship between conditional conservatism, unconditional conservatism and earnings quality; therefore, the hypotheses of this research are stated as the following:

First hypothesis: there is a positive relationship between conditional conservatism and earnings quality.

Second hypothesis: there is a positive relationship between unconditional conservatism and earnings quality.

Research Method

The type of research based on its objective is basic empirical one. In this research, data and the primary information are analyzed through the application of statistical methods and the accepted criteria. Also, the present research, from categorizing the researches based on the nature is a correlational one and its objective to examine the impact of interactive relationships among conditional conservatism, unconditional conservatism and earnings quality and the index of stock price in the listed firms in Tehran Stock Exchange.

Statistical Population and Sample

The statistical population of this research is the all of listed firms in Tehran stock exchange. The reason for using this information is its transparency and diversity in listed firms in Tehran Stock Exchange and the period of conducting this research is during 2003-2011 and it is about eight years. For selecting the statistical sampling, the systematic elimination method is adopted. The reason for applying this method is to make homogeneity of the statistical sample with the population and the possibility of generalization of the obtained results of the tests to the statistical population. Therefore, all the firms of statistical population which have the following requirements are selected as the sample and others are to be eliminated; these requirements are determined according to the sampling method and the research variables.

The accepted requirements are as the following:

1. Due to access to the homogeneity of the sample from the numbers of firms during the examined period and because of the necessity of the existence of the reliable information and covering the research period, the firms should exist in Tehran Stock Exchange during 2003-2011.

2. Due to the homogeneity of reporting date, the elimination of seasonal effects and the enhancement of comparability of the financial period of the information are at the end of March of each year.

3. Due to the necessity of calculation of the research variables and testing the hypothesis in the examined period, there should be necessary and disclosed information about each firm.

4. Because of the nature of investment firms, insurance and banks, the financial statements of these firms are different from other firms; therefore, the data of these firms cause the heterogeneity in the statistical sample; thus, all investment firms, insurance and banks are eliminated from the statistical population.

According to the regarded requirements, 103 firms during 2003-2011 period have been selected as the statistical population. The names of selected sample firms are to be mentioned in the following table based on the industry type.

Methods and Tools for Data Collection and Preparation

used. In this research, at first, the library resources including books, journals, theses, articles and internet are used; by using the forms and leaflets, the primary study is conducted regarding the literature, literature review and the theoretical framework of the research. In the following, by applying the information bank (data bank) of Tehran Stock Exchange, the website of research management, development and Islamic studies of Stock Exchange organization[1] and stock software such as Rahavardenovin (new innovation) and Tadbirpardaz

(resource processor), the required data are collected to test the hypotheses.

Statistical Methods and Used Models in this Research

In the present research, in order to have access to the research results, the inferential statistic is to be used. A small group of population is selected in the inferential statistic and the concerned hypotheses of the researcher are to be applied to them; in order to generalize the results obtained from the sample to the total population, a series of statistical tests are to be conducted. Therefore, in this research, after the regression estimate, the classical regression assumptions are to be examined and after understanding the absence of linearity and the absence of the anisotropy (heterogeneity) variance and absence of autocorrelation in the residuals of the research, the T-Students statistic is used for giving significance from statistical perspective of the research variables. So, to test the research hypotheses, at first, the panel or compilation of data should be commented. To achieve this purpose, the F-Lymor statistic is used that its result based on the **Table 2** showing the confirmation of panel data method. On the other hand, the Heisman test is to be used to determine the method of static effects and random effects method, the results of Heisman test shown

in the **Table 2** confirm the method of static effects.

As it was mentioned before; relaying on the statistical results without considering the presumptions of the regression model has no validity and it cannot be used for decision making; therefore, before interpreting the regression results, the classic hypotheses of the model should be tested for confirming the accuracy of results; with regard to the fact that the research data are combined, in order to examine the existence of autocorrelation among the error values of the model, the Brush Gatt Ferri statistic test is to be used; the results of this test based on **Table 3** show that the existence of autocorrelation among the error values is rejected. In this study, in order to check the assumption of the heterogeneity of the variance, the Arch-lm test is used; the results based on **Table 4** show that there is no heterogeneity of variance. To test the linearity, two indices of position and especial values are used, therefore, based on the results of these two tests, the absence of linearity is confirmed in this research; to study the normality of the values of residuals of the model, Jakobra Test and Histogram Diagram of error value are used. The results are based on the normal distribution of the residual values of the multiple-regression model.

According to the hypothesis stated in this research, hypotheses are tested by estimating the coefficients of the regression equation.In this study, the model (1) is used.

Model (1)

$$EQ_{i,t} = \alpha_1 + \alpha_2 CC_{i,t} + \alpha_3 UC_{i,t} + \alpha_4 Z_{i,t} + \varepsilon_{i,t}$$

EQ: Earnings quality, the dependent variable in this study, is calculated through the ratio of the operational cash flows to the net profit of the firm. The enhancement of the operational cash flows to the net profit reflects the improvement of the earnings quality of the mentioned firm. CC_t is the index of conditional conservatism and it is an independent variable and it calculated through the negative ratio of non-operational accruals accumulated during the past three years to the average of total assets accumulated during the past three years. According to **Jang (2008)**, the bad news related to the firm is reflected and accumulated in the non-operational accruals. The non-operational accruals are calculated through the **formula (1)**.

Formula (1)

Non-Operational Accruals= Total Accruals-Changes in Accounts and Receivable Trade Documents- Changes in Inventories-Orders and Prepayment of Expenses + Changes in Payable Trade Accounts+ Changes in Prepayments

UC is the index of unconditional conservatism and it is an independent variable and it is calculated through the

negative ratio of the average of total accruals before depreciation during the past three years to the total assets during the past three years. (Biddle, 2010)

Formula (2)

$$\text{Unconditional Conservatism} = \frac{\text{Total Accruals} \times -1}{\text{Average of Totall Assets}}$$

Z is the sum of the effective controlled variables on earnings quality based of Yaterdis' article (2011); ROA, the assets returns, is calculated through the ratio of operational earnings to the average of assets. MVBV is the ratio of stock market value to the book value of shareholders' rights (equity of holders). TLSFU is the financial leverage and it is calculated through the ratio of total debts to the rights of shareholders (equity of holders). OCF is the ratio of operational cash flows to the average of assets. ROE is the returns of shareholders' rights(equity of holders), which is calculated through the ratio of net profit to the average of shareholders' rights(equity of holders).

Test Results of Research Hypotheses

According to **Table 5**, the probability value of T-statistic for the conditional conservatism variable which is equal to 0.04 and it is less than the error level which is equal to 0.05. (*p-value*≤ 0.05); therefore, there is a significant relationship between conditional conservatism and earnings quality. In other words, the conditional conservatism of the firm has an impact on

the earnings quality of the listed firms in Tehran Stock Exchange; so, the first hypothesis is confirmed. Also, according to **Table 5**, the probability value of T-statistic for the unconditional conservatism variable which is about 0.004 and it is less than the error level which is equal to 0.05. (*p-value* ≤ 0.05) Thus, there is a significant relationship between unconditional conservatism and the earnings quality of the firm. In other words, the unconditional conservatism of the firm has an impact on the earnings quality of listed firms in Tehran Stock Exchange; so, the second hypothesis is confirmed. Also, the determination coefficient is an indication of appropriate processing of the pattern and the used variables

indicate the capability of model justification about 72 percent. The value of adjusted R^2 of the model is 0.64 showing that 64 percent of changes of dependent variables are justified by the independent variables; in other words, 72 percent of changes of dependent variables are related to the independent variables. Because the applied method is panel data and it is a good number (Figure); Watson Camera test shows the absence of autocorrelation and shows the figure 2.29. F-statistic in this process rejects that the coefficient are equal to zero. The signs of coefficients are all consistent with the theory and theoretical bases presented in the second chapter of this

dissertation and the coefficient probability indicates the impression of total used

variables in this study and their significance.

Table 1: Combination of Sample Firms Based on the Industry Type

Row	Industry Type	Numbers of Firm	Row	Industry Type	Numbers of Firm
1	Extracting of all Mimes	1	11	Basic Metals	10
2	Metal Extraction	1	12	Sugar	1
3	Publication and Printing	1	13	Ceramic and Tiles	7
4	Vehicles and Manufacturing Parts	15	14	Rubber and Plastic	1
5	Computers and Related Activities	2	15	Machinery and Electric Apparatus	1
6	Manufacturing of Metal Products	5	16	Machinery and Equipment	3
7	All Products of Non- Metallic Minerals	3	17	Food and Beverage Products Except Sugar	9
8	Cement, Lime and Plaster	8	18	Textiles	2
9	Chemical	12	19	Pharm Material and Products	19
10	Oil Products	2	-	Sum	103

Table 2: Test for Estimate Model by the Combined (Compound) Data

Level	F-Lymor Test			Heisman Test		
	Statistic	Probability	Outcome	Statistic	Probability	Outcome
Total Firms	314.54	0.0	Panel Data	164.05	0.000	Static Effects

Reference: Research Findings

Table 3: Test Results of the Absence of Autocorrelation among Residuals

Level	P-Value	Obs R-Squared Statistic	F-Statistic	Outcome
Total Firms	0.96	8.7	0.4	Absence of Autocorrelation

Reference: Research Findings

Table 4: Test Results of Residuals Variance Heterogeneity

Level	P-Value	Obs R-Squared Statistics	F-Statistics	Outcome
Total Firms	0.15	18.58	1.63	Homogeneity of Variance

Reference: Research Findings

Table 5: Results of Combined (Compound)Regression Estimate during 2003-2011

Variable	Coefficient	Standard Deviation	T- Statistic	Coefficient of Significance
CC	0.753895	0.3480014	2.166356	0.0482
UC	0.708927	0.2483296	2.854667	0.0046
OCF	8.819004	2.63252	13.92712	0.000
TLS	-0.044854	0.0163825	-2.737511	0.0065
MVBM	0.025144	0.346561	0.725529	0.0076
ROA	4.772854	0.06378796	7.482375	0.000
ROE	0.297062	0.0450164	6.598977	0.008

Watson-Camera Statistic	Determination Coefficient R^2	F-Statistic	Significance of F-Statistic	Adjusted R^2	F-Lymore Statistic
2.29	0.72	8.36	0.00	0.64	314.54

Reference: Research Findings

SUMMARY AND CONCLUSION

In this study, the relationship between conditional, unconditional conservatism and earnings quality has been examined. The necessity of conducting the present research is the identification of accounting conservatism as a beneficial mechanism in financial reporting and its impact on development of a margin of safety for shareholders and creditors regarding the correct application of the firm's resources and the beneficial impact on the earnings quality. So, the main objective of the present research is to determine the relationship between conditional and unconditional conservatism and the earnings quality of the listed firms in Tehran Stock Exchange. The present research is categorized in the field of behavioral research because it deals with the behavior of dependent variables in relation to the independent variables. The nine-year study period of the present research is designated during 2003-2011; the spatial domain of the present research is the listed firms in Tehran Stock Exchange. The present research attempts to study the impact of conditional and unconditional conservatism as independent variables on the earnings quality as a dependent variable. According the nature, it is descriptive-correlational one. In the present study, the systematic elimination method is used to determine the statistical sample. The reason for the application of this method is the development of homogeneity of the statistical sample with total population and the possibility of generalizing the results obtained from testing to the statistical population; Excel and A-Views are applied in order to do the calculations, prepare the data and also analyze them. According to the mentioned variables, the research hypotheses include: first hypothesis: there is a positive relationship between conditional conservatism and the earnings quality; second hypothesis: there is a positive relationship between unconditional conservatism and the earnings quality. According to the hypothesis stated in the research, the hypotheses are tested by estimating the coefficients of the regression equation. The inferential statistics has been used to achieve research results in this study. T-test has been used to determine the significance of correlation and regression coefficients. The conducted statistical analysis shows that there is a positive and significant relationship between conditional conservatism and the earnings quality in the listed firms in Tehran Stock Exchange. Therefore, it can be said that the first research hypothesis is confirmed. In other words, the enhancement of the index of negative ratio of non-operational accruals accumulated during the past three years to

the average total assets accumulated during the past three years as an index of conditional conservatism increases the earnings quality index at the agencies in Tehran Stock Exchange. It can be said that the returns of assets, the ratio of stock market to the book value of shareholders' rights (equity of holders), the ratio of operational cash flows to average of assets and the returns of shareholders have a positive and significant impact onthe earnings quality; and the financial leverage shows a negative and significant impact on the earnings quality; the leverage ratios must be controlled in order to increase the earnings quality.The results of this research indicate that in order to enhance the earnings quality, the firms should increase the conservatism indices. The results of this research are in accordance with the results of **Mohhamadabadi, Mashayekhi and Mirziei (2012), and Penman (2001)**. Also these results are not in accordance with the findings of **Ismail and Elbolok (2011)**. Also the conducted statistical analysis indicates that there is a positive and significant relationship between conditional conservatism and the earnings quality of listed firms in Tehran Stock Exchange. Thus, it can be said that the second hypothesis is confirmed. In other words, the enhancement of the index of negative ratio of average of total accruals accumulated

before depreciation during the past three years to the average of total assets during the past three years as unconditional conservatism increases the earnings quality index at the agencies in Tehran Stock Exchange. Generally, it can be said that the enhancement of conservatism causes the enhancement of the earnings quality and presentation of appropriate financial reports in relation to the firms which can lead to making more rational decisions by investors; these results are in accordance with the results of **Penman (2001) and Giuly and Hayen (2000)**. Also these results are not in accordance with the findings **of Ismail and Elbolok (2011)**.

Research Limitations and Problems

The limitations in conducting the research and interpreting the research results and generalizability of them should be considered and they are as the following.

1-Due to the application of systematic elimination method in selecting the statistical sample, the selective commercial units indicate the limited number of listed firms in Tehran Stock Exchange. Therefore, the generalization of results to the commercial units and industries, that have already been listed in Tehran Stock Exchange but there were not selected in the sample, should be treated with caution. Since, provided financial statements based on total historical costs have been used for

calculating the research variables; therefore, the effects of inflation have not been considered in the interpretation of the research results. The research results may be different from the current ones in the case of information adjustment of financial statements based on the inflation.

Suggestions Based on Research Findings

Based on the research results and positive and significant effects of conditional and unconditional conservatism indices on the earnings quality, the most important suggestion of using management is the enhancement of conditional and unconditional conservatism to increase the earnings quality. In other words, to increase the earnings quality in listed firms in Tehran Stock Exchange, the negative ratio of average of total accruals before depreciation during the past three years to the average of total assets during the past three years as the unconditional conservatism and the negative ratio of non-operational accruals accumulated during the past three years to the average of accumulated assets during the past three years as an index of conditional conservatism should be increased. In accordance with the research results indicating that there is a positive and significant impact of conditional and unconditional conservatism on the earnings quality, the most important recommendation is to increase the conservatism in the

management of economic agencies (enterprises).On the other hand, according to the estimation results, to improve the earnings quality, the enhancement of indices of assets returns, the ratio of stock market value to the book value of shareholders' rights (equity of holders), returns of shareholders' rights (equity of holders) and the ratio of the operational cash flows to the average of assets at the economic agencies (enterprise) should be regarded. Also, in accordance with the research results, it is recommended that the ratio of firm's debts should be controlled to increases the earnings quality. In other words, reducing the leverage ratios can increase the operational cash flows to the net profits.

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