The Relationship between the Composition of the Board of Directors and the Principle of Conditional Conservatism in Tehran Stock Exchange

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Abstract: According to forecasts made by researches and theory as board of directors has greater importance which itself is a function of the percentage of non-bound active members, this monitoring can be done better and providing financial statements will be carried out by higher quality. This study examines the effect of board members composition on the principle of conservatism in the Tehran Stock Exchange. Attracting investors in the capital market of our country due to the novelty of this capital market according to managers has been very important compared to developed countries and in order to achieve this goal, identifying the factors such as: the composition of the board members and conservatism can play a vital role in achieving the ultimate goal of the company. The statistical population of this study includes all companies listed in Tehran Stock Exchange. In this study the samples started with the whole population and the number of sample was determined based on the systematic elimination. In order to investigate the research topic we have used the information related to the 90 companies listed in the Tehran Stock Exchange for the fiscal years 2009-2014. The research method in terms of purpose is applied, in terms of data is quantitative, in terms of the type of reasoning is inductive, in terms of method and nature is analytic and correlational and in terms of the time of the research ex post facto analysis. For data collection, Codal software was used and to test the hypothesis by using combinational method, t and F tests and Durbin-Watson were used. The results show that there is a significant relationship between the composition of the board members and conditional conservatism.

Keywords: Board bound members, non-bound board members, and Conditional conservatism

Introduction
The growth of Tehran Stock Exchange in recent years has led to useful experimental researches in the field of accounting and finance. In this study to promote the field of accounting literature, the effect of board members composition on the principle of conservatism has been investigated among the companies in Tehran Stock Exchange. The importance of conservatism for actual and potential shareholders is one of the important motivations of the present study. Two statistical hypotheses were tested by multiple regression model and analysis of the combined data.

Conservatism in accounting means the difference in selecting policies and it is accepted in good and bad news. The good news is positive stock returns or events to increase profits, and the bad news is zero or negative stocks returns that are about to decrease the profits. Thus, conservatism has been defined as a process of reducing profits and showing the assets lower than the actual level in response to bad news, and in contrast it has been defined as lack of benefit increase and showing the assets more than its actual amount in response to good news (Basu, 1997).

In recent years, many researchers have attempted to provide criteria for measuring conservatism that in this study Basu’s model will be used with regard to the aspects of profit and loss and the ratio of market value to book value model that is a balance sheet model.

Problem Statement
Conservatism financial statements preparation adds to the reliability of accounting information, conservatism indicates the ability of economic benefit to reflect economic benefit (positive returns stock) and economic loss (negative stock returns). Conservatism emphasis on distinguishing between positive and negative stock returns (profit and loss economics) (ibid).

Basu (1997) defined Conservatism as accountants’ tendency to acquire a higher degree of demonstrable benefit to distinguish good news from bad news. Basu, in fact, from the perspective of the definition of profit and loss defined conservatism and by asymmetric behavior of benefit toward good and bad news referred to it. He uses this definition to design a criterion for conservatism assessment and in order to operate and formulate the relevant criteria considered positive and
negative stock returns as a substitute for good and bad news and his definition. Thus, this definition of conservatism considers the relationship between profits - returns.

Thus, based on the definition of conservatism in the years after 1997 and following the widespread use of Basu’s criteria for evaluation of conservatism in accounting research, the researchers aimed to investigate more about this criterion. They by investigating the relationship between these measures and other measures of Conservatism, especially with Market to Book Ratio (MTB) they have found new fields of inquiry and they expressed the ratio of market value to book value as a measure of Conservatism (Kordestani and Amir Beigi, 2007).

Board of Director as an important component of corporate governance and next to management and shareholders plays a major role with regard to the stakeholders. Facts suggest that firm managers have been pursuing their own interests more that stakeholders’ interests. There are 2 ways to solve the problem: first, to encourage managers to do a behavior, a reward should be considered form them. The second method is empowerment of the Board of Directors in such a way that they can properly monitor the performance of managers. According to forecasts made by research and theory as board of directors has greater importance which itself is a function of the percentage of non-bound active members this monitoring can be done better and providing financial statements will be carried out with higher quality.

**Literature Review**

Pourzamani and Mansouri (2015) in their study evaluate the effect of disclosure quality, conservatism and their mutual relationship on the cost of common stock. Statistical population consists of all companies listed in Tehran Stock Exchange. The statistical population of this study based on screening method includes 93 companies. The results of the first hypotheses test by using panel data indicate that the quality of disclosure and conservatism has the opposite effect on the cost of common stock so that by increasing the quality of disclosure or the conservatism the cost of equity capital will be reduced. Also in line with investigating the interaction between conservatism and disclosure quality on the cost of common stock research findings confirm that the by increasing the quality of disclosure the effect of conservatism on the cost of common stock will be reduced. The results of this study could be explained from the perspective of conservatism contract theory and the theory of information asymmetry.

Hassas Yeghaneh et al. (2014), in a research studied the relationship between some of the corporate governance mechanisms with optional and non-optional accruals in companies listed in Tehran Stock Exchange. The sample consisted of 120 companies during the years 2003 until 2009. To measure the quality of accruals, the Francis’s (2005) model was used. Corporate ownership structure, board composition, the type of auditor and internal audit were considered as mechanisms of corporate governance and by using a multivariate regression model, the relationship between ownership structure and board composition was tested with non-discretionary and discretionary accruals quality. To test relationship of the type of audit institutions and internal audit comparing the two communities mean test was used. The results suggest that the relationship between ownership structure and direct and significant optional and non-optional accruals is negative and significant. But between the variables of size of audit firm and the internal audit with discretionary and non-discretionary accruals there was no significant relationship.

Kordestani and Khalil (1392) examined the relationship between benefit conservatism and balance sheet conservatism. In this study Basu's model (1997) was used to measure the conservatism and to measure the balance sheet conservatism the Market to Book Ratio of the share holders was used. For this purpose, data from the 11 companies listed in Tehran Stock Exchange during the years 2011 to 2015 were analyzed. The results showed that for all the studied period profit is not conservative and between profit conservatism and balance sheet conservatism with accruals conservative there is a negative relationship.

Karami and Omrani (2010) examine the relationship between the effect of life cycle of company and conservatism on the value of the company. The results show that in the early stages of growth and maturity, investors paid more attention to net operating assets and abnormal operating profit of conservative corporations (than firms that use aggressive accounting practices) and in the stage of decline, the opposite is true.

Mehrani, Wafi, Thani and Hallaj (2010) examined the relationship between firm size and debit contracts with conservatism. To measure conservatism based on market value and the relationship between stock returns and profits they used accrual-based assay share. Their findings show that there is a significant positive relationship between debt and conservative in two assays based on the accrual and market value. The negative relationship between firm size and conservatism was confirmed in criterion which was only based on market value.

Howe et al. (2014) in their study explore debt financing and accounting conservatism in Korea's private companies. In this study 79,003 observed financial information during 1995-2006 were used as statistical sample. They used Basu's model (1997) and Ball and Shivakumar's (2005) model as a measure of accounting conservatism. The findings of the their research show that between debt financing and accounting conservatism based on Basu's model (1997) there is a negative correlation and between debt financing and accounting conservatism bade on the Ball and Shivakumar’s (2005) model there was a significant positive relationship.
Ahmad and Duellman (2011) found that accounting conservatism of company board helps in reducing agency problems. The results show that the percentage of executive managers (non-executive) has negative (positive) relationship with accounting conservatism.

Kang and Kim (2011) investigated the relationship between corporate governance and profits management based on actual activity in Korea and extended it to the firm's operations study. The goal of their research was to test if these causal relationships between corporate governance and earnings management reinforce the company's performance. They examined 1104 companies listed in the Korean stock exchange and pursued two hypotheses. First, whether earnings management based on actual activity could be directly or indirectly affected by features such as size, activity, and independence of the board of directors? And second, whether management unusual actual activity enhanced the relationship between corporate governance and firm performance and act as an intermediary. Their research results indicate that if the company has developed a system of good governance, earnings management on the basis of actual activity would be decreased and this earnings management can enhance the causal relationship between corporate governance and corporate performance. They also found that the actual activity-based earnings management effectively is controlled by corporate governance system and provides communicate between corporate governance and firm performance.

Larcker, Ormazabal and Taylor (2011) studied the market reaction to corporate governance practices. They indicated that regulatory measures by finding unusual returns, reduction in payments to the CEO, the large stake holders’ number, institutional investors’ mistakes and presence in the board, will destroy values.

Larcker, Ormazabal and Taylor (2011), with regard to the legal and regulatory measures evaluated the relationship between the market reactions to corporate governance. They proved that abnormal returns are associated with corporate governance structure, reduction in the number of bondholders, senior executives’ payment, institutional investors’ easy access to forms of proxy and the passive board presence.

Aggarwal, Ferreira and Matos (2011) by analyzing the portfolio of the institutions during the years 2003 and 2008 claimed that the institutional investors can have effect on corporate governance. They proved that changes in institutional investors can create positive change in control at the corporate level; however, they found no effect of monitoring on institutional investments. In addition, they stressed that company with more institutional performance can easily end weak performance and create progress.

Chung and Shen (2009), revealed the impact of corporate governance structure to increase research, development and capital investment decisions. They found that higher managerial monitoring has higher unusual returns on investment decisions; however, the structure of the supervisory board uses abnormal stock for investment decisions and research and development. For instance Beatty, Weber and Yu (2008) assess the conservative conditions included in debt contracts have; they found that when debt agency costs is higher the conditions more will be used. However, their evidence indicated that contractual term alone does not satisfy the demand for conservatism creditors, and it is necessary to reduce agency costs of debt, conservative accounting is used.

Ahmad and Duellman (2007) examined the relationship between conservatism with corporate governance mechanisms. They use firm size, debt and growth opportunities as control variables. By sing three conservatism criteria, asymmetry, accruals, and market values showed that between the company and conservatism sizes measured using: A) there is a significant positive correlation based on criteria accruals, b) there is no significant relationship based on the market value criterion, and c) there is no significant relationship based on asymmetry measure.

Research Practical Concepts and Variables Definition
Board Bound members: These are Board members who in addition to the responsibilities of board membership should have physical presence (as well as the company's executive management position).
Board non-bound members: Are board members that do not have physical presence in the company and only take part in the decision-making and decision-making.
Corporate governance: Is laws, regulations, structures, processes, cultures and systems that achieves the goals of accountability, transparency, fairness and the rights of stakeholders (Hassas Yeghaneh, 2006).
Board: The board members are appointed by the stock owners of a company and may be selected from among the two groups. The first type includes people who are elected from within the company and the second type includes those who are elected outside of the company and are independent of it. The role of the board is monitoring the company's executives and acting on behalf of shareholders. In fact, the board tries to ensure that shareholder interests are properly maintained.
Accounting conservatism: There are several definitions of conservatism in accounting literature. According to Giuli and Hine (2000) conservatism is choosing an accounting approach under conditions of uncertainty, which ultimately leads to providing the lowest assets and income and have the least positive impact on the equity. Watts and Zimmerman (1986) defined conservatism as: conservatism means that accountant of possible values, report the minimum values for assets and for liabilities reports the highest value. Revenue should be recognized later rather than sooner.
Conditional conservatism (profit and loss conservatism - preset conservatism)
Conditional conservatism is conservatism that is required by accounting standards. It means the recognition of the level of losses in the case of news (negative stock returns) and undesirable, and lack of recognition of profits when there is good news (positive stock return) and favorable. For example, the lowest cost or net sales in inventory valuation is a sort of conditional conservatism. This type of conservatism is called income conservatism or retrospective conservatism (Rayan, 2006, 525-511). Basu, (1977) defined conservatism as an issue required a higher degree of approval for the recognition of good news such as profit, and to know the bad news as losses defines. This definition describes conservatism in terms of profit and loss, which represents that conservatism is conditional. This definition has been approved according to studies in the capital market by Larava and Saha (Basu, 1977, 37-3). Also contract interpretation, interpretation, rights conditional interpretation lead to conditional conservatism (Qiang, 2007, 796-759).

The method
This research in terms of purpose is applied research and panel data regression was used by generalized least squares method. Applied research aimed at the development of practical knowledge in a particular field. In other words, the practical research is guided to the practical application of knowledge. It includes a set of methods which try to describe the conditions or phenomena. Current research in terms of research method is descriptive - correlation that in order to discover correlations between variables will act as ex post facto. Descriptive research includes a set of methods that aim to describe the studied conditions or phenomena and do not explore the phenomenon, but it is intended to describe the relationship between two variables by collecting data and comparing them.

Research hypotheses
The main Hypothesis
There is a significant relationship between the composition of the Board of Directors and conditional conservatism.

The first subsidiary hypothesis
There is a significant relationship between the number of bound members of the Board and conditional conservatism.

The second subsidiary hypothesis
There is a significant relationship between the number of non-bound board members and conditional conservatism.

The statistical population
The statistical populations are the subjects that have a number of homogeneous and measurable features. The level of research community becomes clear by its definition. The statistical population of this research includes those companies listed in the Tehran Stock Exchange from 2008 until the end of 2014, and was serving in Tehran Stock Exchange. The quality of information and ease of access to information of financial statements and other information is the most important reasons for choosing this population.

The statistical sample
In this study, the sample to be an appropriate representative of the target population, for sample selection, Criteria-Filtering Technique was used. The following conditions will be considered for the selection of the statistical sample and the sample can be achieved with systematic elimination method. Companies must provide enough information to all financial statements, including balance sheet, income statement and cash flow. Companies must be active during the financial year in the stock exchange. Company's fiscal year will be ended in March. Firms’ data should be available. Corporations should not be financial Intermediation.

In this study systematic elimination sampling method was used. So that all the companies which were members of the population who meet the above criteria, were chosen as samples and companies that are not qualified will be removed from the study. According to the terms above the 90 companies were selected as the sample.

Data analysis
Since the aim of this study was to investigate the correlation coefficient and estimate the coefficient of determination, to test the hypotheses, panel data regression method was used based on the consolidated generalized least squares method. In order to determine whether the use of panel data in estimating the model would be effective or not, Chow test or F bound will be used and in order to determine which method (fixed effects or random effects) is more appropriate to estimate the Hausman test will be used. According to the results of Chow and Hausman tests, the research model will be predicted by using panel data method and fixed or random effects. In this study, a statistical method used is panel data method. First panel data methods
and the statistical tests that are related to this method will be described. Then, test of the significance of the variables and significant of the model will be explained. Finally, after describing the regression tests, the way of making good decisions about accepting or rejecting hypotheses will be indicated. Data analysis was performed by SPSS software version 22 and Eviews version 7.

**Testing the classical regression hypotheses**

Before the estimating the model of hypotheses testing, it is necessary to examine the assumptions of the classical regression model. The most important hypotheses are those hypotheses that led to a disturbing regression results. To do this JB test (Jarque–Bera test) was used in the Eviews software (version 8). Jarque–Bera test statistical hypotheses are as follows:

- $H_0$: Normality
- $H_1$: Abnormality

If the p-value is smaller than 0.05 $H_0$ is rejected and $H_1$ is accepted and if the p-value is greater than 0.05 $H_0$ hypothesis is confirmed and $H_1$ can be rejected.

**Table 1: Residuals normality test results**

<table>
<thead>
<tr>
<th>Test</th>
<th>Variable</th>
<th>First</th>
<th>Second</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jarque Bera</td>
<td></td>
<td>2.31</td>
<td>1.888</td>
</tr>
<tr>
<td>p-value</td>
<td></td>
<td>0.111</td>
<td>0.175</td>
</tr>
</tbody>
</table>

Source: The researcher’s calculations

As it can be seen in Table 1, residuals normality test statistic and its significance level indicate that $H_0$ hypothesis has been confirmed. In other words, residues of estimating the regression models of the study are normally distributed.

**Results of Hypotheses Research Testing**

The first the main hypothesis
There is a significant relationship between the composition of the Board of Directors with conditional conservatism.

The first subsidiary hypothesis
There is a significant relationship between the number of bound members of the Board and conditional conservatism.

The second subsidiary hypothesis
There is a significant relationship between the number of non-bound board members and conditional conservatism.

**The Results of the First Subsidiary Hypothesis Estimation**

To test the hypotheses, the significance of the regression coefficients will be used. The significant test of the coefficients difference is what the researcher is looking for. In fact, this test in addition to identifying the significance of the coefficients is used to multiply those coefficients with dependant variable. The statistic which is used to determine the significance of coefficients is the Student statistic.

Given that our approach is combinational and in this method we should consider that among the methods of integration (common effect) or panel data (fixed effect and random effects) which must one be selected, so we did Chow test to choose between combinational procedure (common effect) and panel data and Hausman test to select between fixed and random effects. If Chow test is not significant is the common effect method but it is significant between fixed and random effects Hausman test should be done. If the test statistic is not significant, the selection method is random, otherwise method should be based on the fixed effects estimates model. Table 2 shows that a Chow test and Hausman test are significant. Therefore regressions should be estimated based on fixed effect.

<table>
<thead>
<tr>
<th>The tested model</th>
<th>Type of test</th>
<th>Test statistics</th>
<th>p-value</th>
<th>Test result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model (1)</td>
<td>Chow test</td>
<td>2.776</td>
<td>0.0000</td>
<td>Performing Hausman test</td>
</tr>
<tr>
<td></td>
<td>Hausman test</td>
<td>2.444</td>
<td>0.000</td>
<td>Panel Data Fixed effects model</td>
</tr>
</tbody>
</table>

Source: The researcher’s calculations
Table 3.

<table>
<thead>
<tr>
<th>Description</th>
<th>Coefficient</th>
<th>t-static</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant coefficient</td>
<td>-0.765</td>
<td>-1.408</td>
<td>0.0799</td>
</tr>
<tr>
<td>D</td>
<td>0.024</td>
<td>1.775</td>
<td>0.0382</td>
</tr>
<tr>
<td>R</td>
<td>0.025</td>
<td>1.994</td>
<td>0.0233</td>
</tr>
<tr>
<td>D * R</td>
<td>0.064</td>
<td>1.319</td>
<td>0.0939</td>
</tr>
<tr>
<td>D-member* D</td>
<td>0.0237</td>
<td>2.1669</td>
<td>0.0153</td>
</tr>
<tr>
<td>D-member* R</td>
<td>0.1021</td>
<td>2.696</td>
<td>0.0036</td>
</tr>
<tr>
<td>D-member* D * R</td>
<td>-0.424</td>
<td>-4.775</td>
<td>0.0000</td>
</tr>
<tr>
<td>SIZE</td>
<td>0.111</td>
<td>2.745</td>
<td>0.0031</td>
</tr>
<tr>
<td>SIZE* D</td>
<td>0.025</td>
<td>1.900</td>
<td>0.0290</td>
</tr>
<tr>
<td>SIZE* R</td>
<td>0.164</td>
<td>3.319</td>
<td>0.0005</td>
</tr>
<tr>
<td>SIZE * D * R</td>
<td>0.137</td>
<td>2.1669</td>
<td>0.0153</td>
</tr>
<tr>
<td>LEV</td>
<td>0.1003</td>
<td>2.6009</td>
<td>0.0048</td>
</tr>
<tr>
<td>LEV * D</td>
<td>0.028</td>
<td>1.790</td>
<td>0.0370</td>
</tr>
<tr>
<td>LEV * R</td>
<td>0.025</td>
<td>1.994</td>
<td>0.0233</td>
</tr>
<tr>
<td>LEV * D * R</td>
<td>0.014</td>
<td>1.989</td>
<td>0.0236</td>
</tr>
<tr>
<td>ROA</td>
<td>0.3237</td>
<td>3.453</td>
<td>0.0003</td>
</tr>
<tr>
<td>ROA * D</td>
<td>0.2431</td>
<td>2.909</td>
<td>0.0019</td>
</tr>
<tr>
<td>ROA * R</td>
<td>0.2001</td>
<td>2.850</td>
<td>0.0023</td>
</tr>
<tr>
<td>ROA * D * R</td>
<td>0.125</td>
<td>2.543</td>
<td>0.0056</td>
</tr>
<tr>
<td>Adjusted coefficient of determination</td>
<td>0.332</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F-static(p-value)</td>
<td>3.614(0.000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Durbin Watson D-W</td>
<td>2.10</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The Results of the Second Sub-Hypothesis Estimation

Given that our approach is combinational and in this method we should consider that among the methods of integration (common effect) or panel data (fixed effect and random effects) which must one be selected, so we did Chow test to choose between combinational procedure (common effect) and panel data and Hausman test to select between fixed and random effects. If Chow test is not significant is the common effect method but it is significant between fixed and random effects Hausman test should be done. If the test statistic is not significant, the selection method is random, otherwise method should be based on the fixed effects estimates model. Table 4-6 shows that a Chow test and Hausman test are significant. Therefore regressions should be estimated based on fixed effect.

Table 4-6: Results of determining the appropriate model in combined data

<table>
<thead>
<tr>
<th>The tested model</th>
<th>Type of test</th>
<th>Test statistics</th>
<th>p-value</th>
<th>Test result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model (2)</td>
<td>Chow test</td>
<td>1.7431</td>
<td>0.005</td>
<td>performing Hausman test</td>
</tr>
<tr>
<td></td>
<td>Hausman test</td>
<td>2.1833</td>
<td>0.000</td>
<td>Panel Data fixed effects model</td>
</tr>
</tbody>
</table>

Source: Researcher’s calculations

Results

The result of the first hypothesis

In the first sub-hypothesis we want to test this issue that there is a significant relationship exist between the composition of the Board members and conditional conservatism or not. The results showed that the type of relationship between the number of Board members and conditional conservatism in the company is inverse correlation. In other words, by increasing the number of members of the Board, conditional conservatism will be reduced. This result can be interpreted this way that since the members of the Board are Executive members; therefore, they tend to identify early profits and late losses to show a good performance. In other words, by increasing the bound board members the reporting quality will be less than desired level and this may be detrimental to investors and can lead to wrong decisions.

The result of the second subsidiary hypothesis

In the second sub-hypothesis we want to test this issue that does a significant relationship exist between the composition of the bound Board members and conditional conservatism. The results showed that the type of relationship is
direct between the number of non-bound board members and conditional conservatism in a company. In other words, by increasing the number of non-bound members of the Board, conditional conservatism has been increased. This result can be interpreted this way that the bound members of the Board who are non-executive members of the board; therefore, they tend to identify benefit have later that the due time and losses early from that the potential can be losses avoided. In other words, by increasing the number of bound board members higher quality of reporting is considered and it is possible to reduce the losses of investors decrease the wrong decisions.

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