The Impact of Timely Identification of Unrealized Losses on Firms Financial Flexibility

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Abstract: Demand for conservative reporting indicated the claim that timely identification of unrealized losses is useful for the users of financial reports. Optimistic view of the company's managers and owners are likely to be reflected in the financial statements. As a result, the pessimism in accounting is necessary for optimistic look to be neutral. Existence of timely identification of unrealized losses procedure in financial reporting responds to a request for modification of data in order to solve these issues. The overall goal of this research is to explain the relationship between timely identification of unrealized losses and financial flexibility of companies listed in Tehran Stock Exchange. Altogether, the recent study focuses on the beneficial and positive aspects of conservatism and it is argued that accounting conservatism may improve financial flexibility. The statistical samples of the research include 95 companies listed in Tehran Stock Exchange whose data has been collected and analyzed from 2010-2014. Generally, the results showed that companies with more conservatism reserves less cash and also are more successful financing through debt and external debt. However, there was not significant relationship between dividend and accounting conservatism.

Key words: Timely identification of unrealized losses, financial flexibility, cash management, cash providing, payment decisions

INTRODUCTION

Based on the principles outlined in the agency theory, generally, the interests of managers and owners of businesses are not parallel and this matter provides incentives for directional financial reporting and contrary to fact by managers (LaFond and Watts, 2008). The results of this operation will be like that a picture of the actual situation of a business unit seems better than actual situation and capital injection motivation and financial resources increased by external organizational people to the company. In such circumstances, principles and procedures of accounting to support the accounting standards setting bodies with the aim of balancing of the optimism of managers, protect the rights of beneficiaries and provide fair financial statements, the concept of conservatism are applied (Basu, 1997).

About the positive effect of conservatism in reducing the motivations of profit-seeking and support the suppliers of the investment corporation interests, many studies have been done. Most of the researches are concerning the financial reporting environment and quality of information presented in the financial statements (Givoly and Hayn, 2000). This study was done to complement the above theoretical studies and to explain the reaction of share holders and creditors to the level of conservatism applied in the financial statements through reflects measurement of the reactions in financial decisions of managers of listed companies in Tehran Stock Exchange.

Statement of the problem: Ball and Shivakumar (2005) stated that the demand for conservative reporting indicate the claim that conservatism is useful for users of the company's financial reports. Optimistic view of the company's managers and owners are likely to be reflected in the financial statements. As a result, the accounting pessimism is necessary to look optimistic be neutral.

Watts in an article on conservatism in accounting stated that because creditors are more interested in potential adverse risks than optimal performance of the firm, debt contracts is one of the most important factors of demand for conservatism. Creditors are interested in earn information of the probability of the debt coverage by net assets and form's cash in the future (Watts, 2003).

About debt contracts in connection with the selection of accounting procedures, there are two alternative hypotheses. The first hypothesis is that conventional dept hypothesis which states that managers are motivated to select aggressive accounting practices

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(non-conservative). The reason of this problem is that debt contract usually has determined terms related to accounting variables (for example, the specified minimum debt ratio) that their violation leads to impose cost on the company. Accounting procedures increasing are profitable to prevent violations of these terms. The second hypothesis suggests that managers can use the non-conservative accounting to increase profits and attempt to reduce the less point of view of the company in the creditors opinion, risk even more trying to reach the company creditors point of view, this matter cause to reduce the expected interest rate of lenders and reduce the contract costs. Mermen showed that debt contracts determined especial conservative accounting methods and in this way, limited management ability to change accounting practices as favorite. In other words, debt contracts are an important cause of demand for accounting conservatism (Nikolaev, 2010).

Overall, the evidence suggests that positive impact the efficient conservatism to protect the interests of financial resources in Suppliers Corporation (investors and creditors). Therefore, expected that the financing of companies that practice in financial reporting practices are conservative, compared to other companies, do with less time and cost than other companies. In other words, it is predicted, more conservative companies, easier and faster access to their cash. This is because of trusted sponsors to such companies and their desire to expand their investments in them. Based on the above topics, the recent research basic question is as the following:

- Does applying more conservative practices in reporting cause to increase financial flexibility?

Literature review: Beatty *et al.* (2008) consider conservatism conditions included in debt contracts, they are expressed as the agency costs of debt is higher, the contractual terms are used more. However, his evidence showed that the contractual provisions of conservatism's creditors demand alone does not satisfy and therefore, its require to be use of accounting conservatism in order to reduce the agency costs (Beatty *et al.*, 2008).

Zhang (2008) investigated the benefits of accounting conservatism for the parties of the contract. His findings showed that despite the use of conservative accounting that exist in the terms for accounting conservatism in debt contracts if the creditor violation of these terms of advantages, they interested in advantages such as debt maturities and impose penalties for violations of the early recipients of credit (Zhang, 2008).

Lee did a research on the relationship between conservatism and financial costs. The results indicate a negative association between conservatism and financial costs. They show that conservatism could reduce the cost of companies financing.

Bani Mahd based on data from an 11 years period from 1994-2004 from listed companies in Tehran Stock Exchange, determine affecting actors of accounting conservatism and suggested a model for measurement. His results showed that accounting conservatism and profitability indicators (return on assets) in Iran during the study period, decreased in a same time. Firm size and tax have no effect on the accounting conservatism and conservative accounting cannot be considered as an efficient contracting mechanism for reducing conflict between shareholders and creditors of the dividend.

MATERIALS AND METHODS

Research method in the aspect of implementation is descriptive and a kind of correlational research. It is descriptive because its aim is to describe the situation or phenomenon under the study and it's better to understand the present situation and the correlation because in this research, relationship is among the variables because and regarding to this aspect, the purpose of the research is applied research. Because the relationships among the variables in the Stock Exchange, be reviewed.

The hypotheses of the research:
- Through increasing timely identification of unrealized losses, financial flexibility increases

The secondary hypotheses:
- Through increasing timely identification of unrealized losses, the reserved cash balance is reduced
- There is a direct relationship between timely identification of unrealized losses and the debt financing method
- The dividend presentation in firms with higher timely identification of unrealized losses is more than other firms

The research variables and their measurement methods: The research that is based on correlation and causal relationships, the variables was divided into two categories. A set of independent variables and the other variables are dependent.

The independent variables
Method of timely identification of unrealized losses: Based on Basu definition and following to Givli and Heen in this study, measurement of timely identification

of unrealized losses level is based on information provided in the income and loss statement. Therefore, the model proposed in 2008 by Dichev, I.D. and V.W. Tang was used. The criterion had not been used in internal research for the timely identification of unrealized losses before. This method is a regression model in which revenue expenditure is a function of past, current and future costs, respectively:

$$REVENUE_t = \beta_0 + \beta_1 EXP_{t-1} + \beta_2 EXP_1 + \beta_3 EXP_{t-1} + \varepsilon_t$$

Where:
$REVENUE_t$ = Revenue from sales
EXP = Costs (difference between income and net income before unexpected items

If conservative procedure applied in financial reporting, costs will be identified faster and more on time. This is a clear deviation from the matching principle and implicitly causes that the revenue recognized and recorded with a lag. In conclusion in the above regression model, $\beta 1$ that show the severity and type of relationship between costs and revenues during the period t-1 with the revenues of the t period has been proposed as a measure of conservatism.

Financial lever: Ratio of debt to assets as a criterion for determining the capital structure of the companies.

The cash balance: In the first model of this sub-study in this research, the cash balance had been considered as the dependent variable and the third sub-hypothesis model as the independent variables.

Dependent variables
Financing method: The variable estimation method is like that if the company during the financial period, the change in long term debt is more than changes in equity; it seems that participation in financing has been successful through debt financing and financing method considered as a debt in the period. According to this, the DISSUE variable takes a value equals to one.

Presentation of the dividend: Dividend is a part of advantages that given to the shareholder for owning shares and in fact is only a cash payment to joint stock companies to shareholders of corporations. Percentage of the dividend is obtained from cash profit ratio of per share to the realized earnings of per share. Percentage of the dividend is the dependant variable of the third sub-hypothesis and its symbol is the PAYOUT Model assumptions.

The method of the hypotheses test: Models used in the study were to test the hypothesis that was adapted from Lee as follows. The first sub-hypothesis testing:

$$CASH_t = \beta_0 + \beta_1 CONSV_{t-1} + \beta_2 MTB_1 + \beta_3 SIZE_t + \varepsilon_t$$

Where:
CASH = Cash balance (bank balance)
CONSV = The level of accounting conservatism
MTB = Ratio of market value to book value of assets (controlled variable)
SIZE = Logarithm of the book value of assets (controlled variable)

If accounting conservatism increased financial flexibility, it is predicted that the coefficient β_1 is negative and significant. The method of the second sub-hypothesis testing:

$$Pr(DISSUE_t) = \beta_0 + \beta_1 CONSV_{t-1} + \beta_2 (LEVERAGE_t - LEVERAGE_{t-1}) + \beta_3 MTB_t + \beta_4 SIZE_t + \varepsilon_t$$

Where:
$DISSUE_t$ = A dummy variable that if the financing of the company in mentioned period was by the debt, the amount of value equals to one and if the financing was by the new share issue, it will be equal to zero
$(LEVERAGE_t -$ = The difference between the ratio of
$LEVERAGE_{t-1})$ total debt to total assets (leverage ratio) in both period t and t-1

Other variables have been explained previous. Logistic regression was used to test this hypothesis. If accounting conservatism cause to increased financial flexibility, it is predicted that the coefficient β_1 is positive and significant. Method of the third sub-hypothesis testing:

$$PAYOUT_t = \beta_0 + \beta_1 CONSV_{t-1} + \beta_2 CASH_t + \beta_3 CASH_t \times CONSV_{t-1} + \beta_3 MTB_t + \beta_4 SIZE_t + e_t$$

Where:
PAYOUT = Dividend percentage in period t
CASH = The cash balance at period t

In the above regression β_3 is showed the effect of accounting conservatism on the dividend. It expected that this coefficient is positive and significant.

The statistical population and research sample: In present study in order to test research hypotheses, classified and audited financial data of manufacturing companies listed in Tehran Stock Exchange are used.

In order to select the proper statistical sample, in this study, a systematic exclusion of sampling method has been used. Determined conditions to select statistical sample are:

- Company is not investment firms and financial intermediaries
- The end of the financial year ending in March
- The company's fiscal year does not change during the study period
- The trading symbol of the company has not been transferred into the informal board of the exchange

RESULTS AND DISCUSSION

As a result of systematic exclusion criteria and considerations in sampling the target population of 95 companies were selected for the tests.

The results of the first sub-hypothesis test: Based on the estimated determination coefficient, regression model of the first sub-hypothesis testing can explain 38.1% of the change in the cash balance of the firms in statistical population through the changes in the level of conservatism and control variables of the sample firms (Table 1).

Durbin-Watson statistic is index to detect the absence of autocorrelation among the remains of the regression model. Optimum level of Durbin-Watson statistic is between 1.5-2.5. As the results show, there is no autocorrelation among remains as one of the basic hypothesis of the regression is established about the pattern of the first sub-hypothesis.

The significance level of F-statistics is less than significant level test ($\alpha = 0.05$) and thus it can be concluded that at least one of the coefficients β is significant, I the fitted model.

Based on the results, the estimated coefficient for the conservatism variable is 0.115 and the significant level is 0.05. These findings suggest an inverse relationship between accounting conservatism and corporate cash holdings by the sample (Table 2). These findings are according to the theoretical hypothesis. Because it's predicted, more conservatism company have more financial flexibility, stockpiling cash take fewer precautions.

The results of the second sub-hypothesis test (logistic regression): Percentage correct of the model suggests that 82.8% of observations on the dependent variable are sorted correctly. The coefficient of determination obtained for the hypothesis test pattern is 0.319. This

Table 1: The results of statistical analysis for regression model of the first sub-hypothesis

F significant level of	F-statistic	Durbin-Watson statistic	R^2
0.017	33.417	1.674	0.381

Table 2: The results of the statistical analysis for the coefficients of the pattern of the first sub-hypothesis test

Variables	Standardized (β)	Significant level of p-value	t-statistic	Co-liner tests Variance inflation factor	Tolerance
CONSV	-0.115	0.084	-2.021	1.019	0.981
MTB	-0.013	0.778	-0.282	1.001	0.999
SIZE	0.149	0.002	3.089	1.018	0.982

Table 3: The results of the statistical analysis for regression testing sub-second model

Correction percentage of the model	Nagelkerke (R^2)	Chi-square	Significant level of Chi-square
82.8	0.319	42.225	0.013

Table 4: The results of the statistical analysis for coefficients of the second sub-hypothesis regression of the independent variables test

Variables	Significant level of percentage correct of the model	Parent statistic	Coefficient size
CONSV	027.0	232.4	1.561
LEVERAGE-LEVERAGE	041.0	329.3	156.0
MTB	369.0	806.0	025.0
SIZE	763.0	091.0	009.0

Table 5: The results of statistical analysis for regression model of the third hypothesis

F significant level of	F-statistic	Durbin-Watson statistic	R^2
0.021	14.275	917.1	248.0

finding suggests that the fitted model could explain 31.9% of the dependent variable by the independent variables changes (Table 3).

Based on the results presented in Table 4 coefficient of variable, conservatism level in the model is 1.561 and significance level is 0.027. The findings indicate a direct and significant relationship between conservatism and financed by debt. The results indicate that the obtained coefficient for the variable LEVERAGE-LEVERAGE$_{t-1}$ is also significant. This variable reflects the change in the debt ratio in period$_{t-1}$ and account as the control variable in the model of hypothesis test. According to the estimated coefficient and the significant level of the coefficient, it can be concluded that there is a significant relationship between the changes in debt financing.

The results of the third sub-hypothesis test: According to the results presented in Table 5, the determination coefficient of estimated for the regression model of the third sub-hypothesis test can explain 24.8% of the changes in dividends and changes in the level of

Table 6: The results of the statistical analysis for the model of coefficients of the third sub-hypothesis test

Variables	Standardized (β)	Significant level of p-value	t-statistic	Co-liner tests	
				Variance inflation factor	Tolerance
CONSV	0.077	0.138	1.484	1.208	0.828
CASH	0.158	0.001	3.303	1.027	0.973
CASH× CONSV	-0.025	0.631	-0.481	1.200	0.833
MTB	-0.007	0.888	-0.141	1.001	0.999
SIZE	0.110	0.024	2.261	1.053	0.950

accounting conservatism control variables. The significance level of the F-statistics indicates that at least one of the β coefficients in the fitted model is significant.

Based on the results, the estimated coefficient for the accounting conservatism variable is 0.077. But in terms of the coefficient, it is not significant statistically. Because of that its significance level is 0.05. Lack of a statistically significant coefficient about CASH×CONSV and MTB is due to the on the variables. In other words, these variables have no significant effect on companies' dividend over the course of the study sample (Table 6).

CONCLUSION

Most of the research discuss and investigate the different financial and company factor that may cause to create conservatism in financial reports (Garcia-Teruel *et al.*, 2008; Ryan, 2006). However, research pay little attention to the economic results or benefits results from the accounting conservatism. Three of the most important exceptions are Ahmed and Duellman (2011) and Zhang (2008) who approved the benefits resulted from the conservatism in the finance market.

The findings of this research, based on the favorable results of conservative accounting are very interesting to access the financial resources and from this point of view, the results of the research are consistent with the above studies. Because it proved that companies with more conservative procedure in financial reporting, probably have more flexibility in financial decisions and it would be beneficial to the company and shareholders. Also, it has positive results in the capital market.

RECOMMENDATIONS

According to the research findings, regarding to the liquidity management, recommended to company's managers that be carefully about the cash preserve in the

company and if access to the financial resources in required time, provide for them, refrain from maintaining extra cash. Because it would cause to create the company's free cash flow and reduce the efficiency of resource manager.

The results of the tests showed that conservative firms probably have more opportunities for financing through debt and it's due to the positive attitude towards these companies. Base on this, recommended to the managers of corporation that if companies want to get loans and financing by borrowings to satisfy creditors, about applying the conservative directions in financial reporting (especially in period that negotiations and consultations to earn credit are following) show greater sensitivity and accuracy.

Also, it is recommended to the investors that before buying shares, will be determined his intention about keeping long term or immediate sale of the purchased shares. This case leads them in evaluating and selecting stocks, correctly. If the target of shareholders is achieve the short-term benefits of owning stock and then sell their shares, its better select the share of firms that are more likely to provide their expectations.

In the research area, it is recommended that future researcher try to design and provides a model for a more accurate measurement of the conservative of Iranian companies. Because, it seems that, models which are commonly used in internal research have no required and appropriate efficiency to reflect conservative directions.

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