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The Relationship between Risk Management Conservatism and Operating Cash Flow

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Abstract -The objective of this research is the analysis of the relationship between risk management conservatism and operating cash flow in accepted corporations in Tehran Stock Exchange. The methodology is the descriptive-correlation and hypotheses are examined by using regression model and panel data method. The chronological period of research is during the years of 2008 to 2013, including statistical samples of research that are consisted of 122 corporations, which are among accepted corporations in Tehran Stock Exchange. The results from the analysis indicates that there is a significant relationship between conservatism and operating cash flow. Furthermore, there is a positive and meaningful relationship between conditional conservatism and unconditional conservatism. Therefore, these hypotheses are at 95% confidence level.

Keywords: *conservatism, conditional conservatism, unconditional conservatism, operating cash flow, panel data.*

I. Introduction

On one hand, the ever-increasing growth of business and commercial activities of the economical units and the active presence of them in the capital market, and on the other hand, specializing the administration of corporations and mounting the shareholders, caused the other owners not to be able to control their corporations and also, by increasing the number of shareholders whose purpose of investments are accumulating the wealth, forced the owners to choose the professional managers who are aware of the complicated economical and financial issues to administrate the corporations which are leading to separate ownership from management. By hiring the managers as agents of owners (shareholders) to administrate the corporations, the agency relationship has been shaped. The agency relationship^[1] is a

¹- *Agency Relationship*

kind of contract that one of the owners or more select an agent or manager to conduct some operations (based on it). The forming of agency relationship brings some contradictory interests that lead to the separation of ownership from management, different goals and lack of correspondence at information between managers and shareholders. (MohseniMaleki, 2014).

Jensen^[1] (1986) believes that conducting the supervising by shareholders on opportunistic behavior of managers which is difficult, allows the managers that spend the produced cash flow within corporations, in their favor not in maximizing the corporation value. In fact, according to the Jensen's idea, the high volume of free cash flow^[2] at a commercial unit, can cause the severe conflict and lack of affinity in managers and shareholders' interests and consequently, increase the agency problems between managers and shareholders. Jensen emphasizes on the importance of controlling systems of corporations in order to hinder the management inclinations and restrict the opportunistic behavior of management. Many previous researches indicate that conservative accounting is a part of controlling systems of corporations to opportunist behavior of managers and can increase the agency problems between managers and shareholders (Mehrani and A.Taherian, 2013).

Managers are capable of those operations that involve them in management of operating cash flow. Operating cash flow is the cash that is attained from frequent operating activities of business. The management of cash flow is defined as the capability of managers at choosing the activities which are considered to change in financial reports in order to mislead the external users by producing the positive results for achieving the contracts of reward. Conservatism is one of the remedies that decreases the agency problems. Conservatism can be titled as a structure that if functions properly, leads to be useful in solving many problems at lack of data correspondence of agency issues that on the whole is derived from the breach between managers and financial resources providers of commercial units. (MohseniMaleki, 2012).

If conservatism is really important in decreasing the agency problems between managers and shareholders, it is expected that whatever the similarity is lower in managers and shareholders' interests, there is more conservatism demand. As illustrated above, according to the Jensen's idea, increasing the volume of free cash flow in a commercial unit can cause the intensity in conflict and the lack of similarity in managers and shareholders' interests and consequently increasing the agency problems between managers and shareholders. As a result, it is predicted that demand for conservatism which is derived from agency problems between managers and shareholders, changes by cash flow amount positively. Considering the theoretical support of this subject, few experimental cases are gathered about this claim in our country. Thus, the purpose of the current research is the analysis of the relationship between operating management conservatism and operating cash flow in accepted corporations in Tehran Stock Exchange.

II.Theories and Literature Review

One of the important aftermath of the dissimilar conservatism behavior about loss and gain is persisting on rendering the pure value of assets less than real condition. Legislating of the capital markets, compilers of standards and scholars criticize the conservatism that this rendering which is far from reality in current period can cause the less than real condition rendering of expenses of future periods and therefore leads to the rendering of more than real profit in the

¹- Jensen

²- Free Cash Flow

future periods. But APB (Accounting Principles Board) categorizes the conservatism as a converting pledge of financial accounting at manifest number 4 and expresses that assets and liabilities often are assessed in an unclear condition to consider and therefore, accountants respond cautiously.

According to Beaver^[1] (1998), the conservatism behavior is in a way that leads to choosing the lower incomes (rather than higher incomes) and higher expenses (rather than lower expenses) and it identifies not-tolerated losses while ignores gains which are not realized yet. Therefore, as Feltham&Ohelson^[2](1995) stated, it is expected that these results lead to make a difference between value of market and clerical value of shares at long run (Shroff et al^[3]. 2004/6).

Researchers utilize three criteria in order to assess the conservatism:

- Criteria of net assets;
- Criteria of profit and responsibility items and
- Criteria of the relationship between profit and the yield of share.

All these criteria are with emphasize on effect of conservatism dissimilarity at identifying the loss and gain (Watts^[4], 2003, 288).

Categorizing types of conservatism

Conditional conservatism (income conservatism–predetermined conservatism)

Conditional Conservatism is a kind of conservatism that is necessitated by the accounting standards. It means identifying the loss immediately in case of bad and inappropriate news (negative yield of shares) and lack of identifying the profit in good and appropriate news (positive yield of shares) for example usage of market rule or net value of sale in assessing the stock are considered a type of conditional conservatism. This type of conservatism is sometimes called income conservatism or retrospective conservatism. (Ryan^[5], 2006, 511-525).

Basu (1977) defines conservatism as having a higher grade of confidence to recognize the good news like profit in contrast with bad news like loss. This definition of conservatism is described in income point of view that indicates the conditional conservatism. Considering the conducted studies this definition is confirmed in the capital market by Lava and Saha's research (Basu^[6], 1977 3-37).

Also, the arbitrary and legal interpretation of conservatism leads to conditional conservatism actions.

Unconditional conservatism (balance sheet conservatism–foresight conservatism)

This type of conservatism unlike conditional conservatism is not necessitated by the accepted standards of accounting and the outcome which is stated less than real clerical value of the net assets by predetermined accounting trends. Also, this type is well-known as the balance sheet conservatism (Ryan, 2006, 511-525).

1- Beaver(1998)

2- Feltham&Ohelson(1995)

3- Shroff et al(2004)

4- Watts(2003)

5- Ryan(2006)

6- Basu

The Feltham and Ohelson's definition is based on the balance sheet point of view. According to this perspective, those cases that, there are real doubts between two or more reporting methods. We must choose the method that has the least appropriate effect on the share owners' rights (Feltham and Ohelson, 1995, 689-731).

Also, the legal and tax interpretations or like these lead to unconditional conservatism (Keyang^[1], 2007, 759-796).

Biddle ^[2] (2013), in his research analyzed the role of the risk management conservatism to operating cash flow. The results of this research indicate that unconditional conservatism brings about a decrease in the descending trend of cash flow.

Talebnia et.al (2012), analyzed the effect of agency problems of free cash flow on the relationship between profit of each share and clerical value of share price. The results of the analysis from 48 corporations during 2002 to 2010 stated that the profit of each share has significant and positive relation to clerical value of share price and agency problems lead to decreasing the relationship between profit of each share and clerical value of the price.

Lee^[3] (2010), in his research, titled the effect of conservatism accounting on financial decisions of corporations, analyzed the relationship between conservatism accounting with inclination to keeping the cash flow and the method of financial security. The results stated that by increasing the conservatism in corporations the cash flow keeps more and they use the spreading shares in order to have financial security.

Chen et.al^[4] (2009), in their research analyzed the relationship between conservatism and leadership system. The results indicate that the corporations with weak leadership prone to more conservatism. These results match with the perspective that proves conservatism can be an effective mechanism in leadership system.

Bauwhede^[5] (2007), in a research, titled the effect of conservatism on the expenses of money borrowing by liabilities, stated that the expenses of liabilities are intensely affected by conditional conservatism and are less affected by unconditional one and corporations that take conditional conservatism have less liabilities than the others.

Haw e.al^[6] (2001), in their research analyzed the data content of operating cash flow, profit and obligation items in China Capital Market and realized that data content of profit are more in relation with operating cash flow. Also, in this study increasing data content of obligatory-arbitrary items confirms the contrasting to obligatory-non-arbitrary items.

Myers and Maljov^[7] (1984), in their research analyzed the financial security and investment decisions and concluded that data dissimilarity is more in those corporations which are more valuable based on chance of growth and the reason of high capital expenses, therefore, they are expected to keep more cash flow.

1- Keyang

2- Biddle

3- Lee

4- Chen et.al

5- Bauwhede, h.w.

6- Haw e.al

7- Myers and Maljov

III. Research Hypotheses

Principal Hypothesis:

There is a significant relationship between risk management conservatism and operating cash flow.

Secondary Hypothesis:

First hypothesis: There is a significant relationship between conditional conservatism and operating cash flow.

Second Hypothesis: There is a significant relationship between unconditional conservatism and operating cash flow.

IV. Methodology

Since this research has pursued the finding of the significant relationship between research variables, the utilized methodology is descriptive-correlation type. The reasoning method is analogical-inductive which means the theories and literature review is extracted from studying at libraries, studying the articles and sites in terms of analogy and gleaning the information to confirm or reject is inductive. In this research with respect to the order of data and statistical methodology of analysis, the panel data is used due to two different aspects which have analyzed the risk management conservatism and operating cash flow. On one hand, these variables are between different corporations and on the other hand, they were tested during 2008 to 2013. In this study, for the purpose of the sample to represent an appropriate case from the statistical group and for selecting the sample, the criteria-filtering technique^[2] (elimination) is used. The following criteria are considered and if a corporation attains all of them it is chosen as a sample.

1. It is chosen in Tehran Stock Exchange before 2007.
2. The fiscal of corporation ends on the last day of Esfand (In March) every year.
3. The corporation didn't change the fiscal in the period of analysis.
4. The corporation under analysis mustn't be a kind of investment, holding, financial broker and insurance corporation.
5. Information and data must be accessible.
6. The transactions of share are formed constantly at Tehran Stock Exchange and the cease of transactions mustn't be more than three months.

V. Model and Research Variables

Model (1): There is a significant relationship between risk management conservatism and operating cash flow.

$$CFO_{i,t} = \beta_0 + \beta_1 CONC_{it} + \beta_2 UNCONC_{it} + \beta_3 SIZE_{it} + \beta_4 LEV_{it} + \beta_5 MB_{it} + \beta_6 LTDEBT_{it} + \beta_7 LIQ_{it} + \varepsilon_{it}$$

CFO: Operating cash flow

CONC: Conditional conservatism

UNCONC: Unconditional conservatism

SIZE: Size of corporation

LEV: Leverage

MB: Corporation growth index

LTDEBT: The structure of due date

LIQ: Other cash assets and

ε : Random error of corporation i at the end of year t.

Model (2): There is a significant relationship between conditional conservatism and operating cash flow.

$$CFO_{i,t} = \beta_0 + \beta_1 CONC_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 LEV_{i,t} + \beta_4 MB_{i,t} + \beta_5 LTDEBT_{i,t} + \beta_6 LIQ_{i,t} + \varepsilon_{i,t}$$

Model (3): There is a significant relationship between unconditional conservatism and operating cash flow.

$$CFO_{i,t} = \beta_0 + \beta_1 CONC_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 LEV_{i,t} + \beta_4 MB_{i,t} + \beta_5 LTDEBT_{i,t} + \beta_6 LIQ_{i,t} + \varepsilon_{i,t}$$

Model (4): The calculations of conditional conservatism: For calculating the conditional conservatism rate in each fiscal, the conditional conservatism criteria of Khan and Watts (2009) is used. C-Score criteria by using the Basu's model (1997) are calculated as the following:

$$X_{i,t} = \beta_1 + \beta_2 D_{i,t} + \beta_3 R_{i,t} + \beta_4 D_{i,t} + \varepsilon$$

X: Operating profit after subtracting the financial expenses that is divided into the value of capital market.

R: The yield of shares at the end of the fiscal.

D: Virtual variable if it is $R_{j,t} < 0$, it will be 1, otherwise it is zero.

β_3 : The criteria of appropriate news being well-timed.

β_4 : The criteria of being well-timed in relation with the difference of bad news to appropriate news.

$$G - SCOR: \beta_{3,i,t} = U_1 + U_2 MKV_{j,t} + U_3 MB_{j,t} + U_4 LEV_{j,t}$$

$$C - SCORE: \beta_{4,i,t} = a_1 + a_2 MKV_{j,t} + a_3 MB_{j,t} + a_4 LEV_{j,t}$$

G-SCOR: The criteria of appropriate news being well-timed

C-SCORE: The criteria of being well-timed in relation with the difference of bad news to appropriate news (conservatism)

MKJ: Natural logarithm of market value of owners' rights.

MB: Corporation growth index.

LEV: Financial leverage.

Considering the ultimate models of conditional conservatism calculation above is:

$X_{j,t}: b1 +$

Model (5): The calculations of unconditional conservatism:

$(-1) \times \text{total assets at the beginning of period} / \text{obligated items-conservatism index}$

Required data of the research in hypotheses testing are gathered by referring to financial auditing statements of accepted corporations in Tehran Stock Exchange and using the Tadbirpardaz software. And also required tools in gleaning information consist of observing, statistical testing, data base, V-Use software and Axel software. And information related to theoretical research gathered by library method and using Persian and Latin articles and books.

VI. The results of research findings

The statistical method of this research is panel data.

Required data of the research for testing the hypotheses multi-variable linear regression is used. It is necessary that before estimating the model, the stability of variables must be analyzed. A variable is stable when the average, variance and self-correlation coefficient are stable during the time. To test the hypotheses, first the correctness of merged data is tested by using the bound test F, then based on Hosman's test the method (stable effects or random ones) is determined and considering the method, it is estimated. For analyzing the significance of the whole model, F statistics are used for assessing the independent coefficient variables in each model and it will be decided at 95% confidence level to accept or reject the hypotheses. Also, in order for the variables to be normal, similarity in error variance and independent of errors, we used tests of Jar Q-Brush-Pagan and Dorbain statistics-Watson in order.

The results of statistical hypotheses model

Choosing the paradigm to research model

Probability of (P-value) of each variable is less than 0.05. So, the research variables are at 95% confidence level of reliability. Also, based on the table 1 the probability of Leamer F for the first model is less than 5%. Therefore, for estimating the first model, the picture method is used and considering the Hosman's test probability or first model probability to be less than 5%, the fixed effects model is used to estimate.

Table 1: The results from F-Leamer and Hosman's tests

Model	Test	Statistics	Probability	Result
First	Leamer F	4.2021	0.0000	Picture result
	Housman	89.6562	0.0000	Fixed effects

The results of first research hypothesis

The aim of the first research hypothesis analyzed whether there is significant relationship between risk management conservatism and operating cash flow. In order to test this hypothesis, the estimation results of the first model, which are presented in table 2, is used. Probability value (or significance level) F equals to zero and because this value is less than 0.05, the zero probability is rejected at 95% confidence level which means the model is significant. The statistics of Durbin-Watson are 2 which indicate the lack of self-correlation. The results related to coefficient show that nearly 62% of dependent variable changes are explained by the dependent variables and control model. In the analysis of significance of coefficients considering the represented results in table 2, statistical probability of t is less than 0.05 for variable coefficient of conditional and unconditional. As a result, the significant relationship between risk management conservatism and operating cash flow is confirmed at 95% confidence level. It means there is a significant relationship between risk management conservatism and operating cash flow. Conditional conservatism (0.00057) and unconditional conservatism (0.260113) variables coefficients are positive that indicate the direct relationship which means by increasing the conservatism, the operating cash flow level will increase and vice versa.

Table 2: The results of model estimation

$CFO_{it} = \beta_0 + \beta_1 CONC_{it} + \beta_2 UNCONC_{it} + \beta_3 SIZE_{it} + \beta_4 LEV_{it} + \beta_5 MB_{it} + \beta_6 LTDEBT_{it} + \beta_7 LIQ_{it} + \epsilon_{it}$				
Variable	Estimation Coefficient	Standard Error	Statistics t	Probability
C	0.669128	0.170980	3.913488	0.0001
Con. Conservatism	0.000547	0.000197	2.777310	0.0057
Un-con. Conservatism	0.260113	0.047485	5.477808	0.0000
Corporation Size	-0.021437	0.008672	-2.472059	0.0138
Financial Leverage	-0.381944	0.093822	-4.070936	0.0001
Corporation Growth Index	0.005450	0.003970	1.372720	0.1704
Due Structure	0.162855	0.043170	3.772413	0.0002
Other Financial Assets	-0.074676	0.080895	-0.923122	0.3564
Assets Determined Coefficient	0.625			
Modified Determined Coefficient	0.532			
Dorian-Watson	2.00			
Statistics F	6.735			
Probability (Statistics F)	0.0000			

Selecting the Paradigm for Research Model

Based on table 3, the probability of F Leamer is less than 5% for second model so the picture method is used to estimate the second model. Considering the probability of Hosman tests and the test probability of second model which is less than 5%, the fixed effects method is used for estimation.

Table 3: The results of F Leamer and Hosmens' Tests

Model	Test	Statistics	Probability	esult
Second	Leamer F	2.5994	0.0000	Picture Method
	Housman	43.1759	0.0000	Fixed Effects

The test results of second hypothesis of research

The aim of the second hypothesis test of research is to determine whether there is a significant relationship between conditional conservatism and operating cash flow.

In order to test this hypothesis, the results of the second model estimation in table 4 are used. Probability value (or significance level) F equals to zero and because this amount is less than 0.05, the zero hypothesis is rejected at 95% confidence level which means the model is significant. The statistics scale of Durbin-Watson is 2.15 that indicates the lack of self-correlation. The determined coefficient results show that nearly 48% of the dependent variables changes are explained by the independent and control variables of the model.

In significant analysis of coefficients, considering the represented results in table 4, since statistics probability of t is less than 0.05 in coefficient variable of conditional conservatism, thus the existence of significant relationship between conditional conservatism and operating cash flow is confirmed at 95% confidence level. This means that there is a significant relationship between risk management conservatism and operating cash flow. This variable (0.000223) is positive that shows the direct relationship that considers the statistics are the coefficient variable of conditional conservatism. It means that by increasing the conditional conservatism, the operating cash flow level will increase and vice versa. The results of the first hypothesis were matched with the Gary et.al (2012), Haw et.al (2009) and Kalon's (2010) researches but considering the relationship, they were conflicted with results of Biddle (2013).

Table 4: the results of the second model estimation

$CFO_{i,t} = \beta_0 + \beta_1 CONC_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 MB_{it} + \beta_5 LTDEBT_{it} + \beta_6 LIQ_{it} + \varepsilon_{it}$				
Variable	Estimation Coefficient	Standard Error	Statistics t	Probability
C	0.947198	0.215793	4.389393	0.0000
Con. Conservatism	0.000223	0.000183	3.220751	0.0027
Corporation Size	-0.042058	0.015113	-2.782931	0.0056
Financial Leverage	-0.393704	0.105494	-3.731990	0.0002
Corporation Growth Index	0.000228	0.004444	-0.051261	0.9591
Due Structure	0.239690	0.075836	3.160646	0.0017
Other Financial Assets	-0.174805	0.073222	2.387314	0.0173
Assets Determined Coefficient			0.485	
Modified Determined Coefficient			0.362	
Dorian-Watson			2.15	
Statistics F			3.928	
Probability (Statistics F)			0.0000	

The selecting Paradigm for the research model

Based on table 4-4, the probability of F learner for the third model of research is less than 5% thus for estimating the third model the picture method is used. Considering the test probability of Hosman and the probability that the third model test is less than 5% the fixed effects method are utilized for estimation.

Table 5: The results of learnr F and Hosman Tests

Model	Test	Statistics	Probability	Result
Third	Leamer F	4.1229	0.0000	Picture Method
	Housman	81.5004	0.0000	Fixed Effects

The results of the third hypothesis of the research

The aim of the third hypothesis test of research is whether there is a significant relationship between unconditional conservatism and operating cash flow.

In order to test this hypothesis the results of the third model estimation in table 5 is used. Probability value (or significance level) F equals to zero and because this amount is less than 0.05, the zero hypothesis is rejected at 95%

confidence level which means the model is significant. The statistics scale of Dorbain-Watson is 2.03 that indicates the lack of self-correlation. The determined coefficient results show that nearly 62% of the dependent variables changes are explained by the independent and control variables of the model.

In significant analysis of coefficients, considering the represented results in table 6, since the statistics probability of t is less than 0.05 in coefficient variable of the unconditional conservatism, thus the existence of significant relationship between unconditional conservatism and operating cash flow is confirmed at 95% confidence level. It means that there is a significant relationship between risk management conservatism and operating cash flow. This variable (0.259392) is positive that shows the direct relationship that considering the statistics t are the coefficient variable of unconditional conservatism. It means that by increasing the unconditional conservatism the operating cash flow level will increase and vice versa. The secondary results of the second hypothesis were matched with the Gary et.al (2012), Kalon's (2010) and Kordestani&Khalili's researches (2010).

Table 6: The results of the third model estimation

$CFO_{i,t} = \beta_0 + \beta_1CONC_{it} + \beta_2SIZE_{it} + \beta_3LEV_{it} + \beta_4MB_{it} + \beta_5LTDEBT_{it} + \beta_6LIQ_{it} + \varepsilon_{it}$				
Variable	Estimation Coefficient	Standard Error	Statistics t	Probability
C	0.583157	0.218837	2.664804	0.0079
Un-con. Conservatism	0.259392	0.045408	5.712504	0.0000
Corporation Size	-0.015265	0.012367	-1.234383	0.2176
Financial Leverage	-0.386237	0.093099	-4.148683	0.000
Corporation Growth Index	0.006744	0.004547	1.483359	0.1386
Due Structure	0.220910	0.042722	5.170917	0.0000
Other Financial Assets	-0.079776	0.079080	-1.008803	0.3135
Assets Determined Coefficient		0.526		
Modified Determined Coefficient		0.618		
Dorian-Watson		2.03		
Statistics F		6.67		
Probability (Statistics F)		0.0000		

VII. Discussion and Conclusion

Operating cash flow is a fund that is extracted from frequent operating business activities (Hartman et.al, 2004), Hili and Valen (1999). The management of cash flow is defined as the capability of managers at choosing the activities which are considered to change in financial reports in order to mislead the external users by producing the positive results for achieving the contracts of reward. Conservatism is one of the remedies that decrease the agency problems. Conservatism can be titled as a structure that if functions properly, leads to be useful in solving many problems in the lack of data correspondence of agency issues that on the whole, is derived from the breach between managers and financial resources providers of commercial units.

VIII. Some Suggestions Based on Research Results

Considering the confirmation of principal hypothesis of research, there is a significant relationship between risk management conservatism and operating cash flow. Investors, creditors and other users of accounting information, need the information related to cash flows to make financial and investment decisions and also, conservatism with decreasing in agency problems can be useful in investment decisions. Therefore, the results of principal hypothesis of research can be very vital to make decisions related to financial security, investors and creditors.

Considering the confirmation of the first side hypothesis of research, there is a significant relationship between conditional conservatism and operating cash flow. These results can be very vital to the corporations in decision making related to financial security, investor and creditors.

Considering the confirmation of the second side hypothesis of research, there is a significant relationship between unconditional conservatism and operating cash flow. These results can be very vital to the corporations in decision making related to financial security, investor and creditors.

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