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Studying the Relationship between Institutional Ownership and Conservatism in Companies Accepted in Tehran Stock Exchange

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Abstract

Due to the problems of representatives, managers of companies might not use company resources to increase wealth of shareholders. Institutional shareholders, as the controlling mechanism of corporate governance, can use their voting power in active monitoring on company's procedures and operations and manager's decisions due to owning a considerable part of company stock. In this research, the attempt was made to determine effects of the presence of institutional owners on conservative accounting. In order to study these communications, Ball and Shivakumar's mode land Givoly and Hayn's regression models along with financial information of 60 companies from 2001 to 2010 were used. The results implied a positive relationship between institutional owners and profit conservatism using both of the mentioned models. Consequently, it could be claimed that these shareholders are active supervisors who encourage managers to report quality profit. Considering the dissimilarity of institutional investors' motivations in monitoring accounting procedures of the company, different relationships of institutional ownership and conservatism were also studied in this research by categorizing institutional investors to active and inactive ones. The results demonstrated an inverse relationship between inactive institutional owners and conservatism using Ball and Shivakumar's model while this relationship was positive and direct in Givoly and Hayn's model. Also, a positive relationship was found between active institutional owners and profit conservatism in both Ball and Shivakumar's and Givoly and Hayn's models.

Keywords: Institutional Owners, Active Institutional Investors, Inactive Institutional Investors, Conservatism

Introduction

With the formation of a representative relationship as a result of the separation of ownership and management, a conflict of benefits is formed between managers as company governors and shareholders. It means that managers might take opportunistic measures and

make decisions which are for their benefits and against share holders'. Since managers are responsible for preparing financial statements, they have complete knowledge about company's situation and higher awareness than consumers of financial statements; thus, they potentially try to present a desirable image from the business unit. The general result of this operation would be an image of the business unit which seems better than its real condition and thus the motivation for injecting investment and financial resources by those outside the organization would increase. In the meanwhile, institutional shareholders, due to possessing a great fraction of companies' stock, are of considerable influence in the mentioned companies and have access to different information regarding future perspectives, company plans and even, in some cases, future contracts of the company. Institutional investors represent one of the powerful governance mechanisms of the company to monitor management of the company because they can have an impressive influence on management of the company and also align management benefits with interests of shareholder groups. One of the effective concepts in financial reporting of companies is conservatism with a long record of influence on accounting. Conservative accounting procedures prevent managers from opportunistic behaviors and excessive optimism in providing profit. The objective of this research was to study the relationship between institutional governance existing in the capital structure of companies accepted in Tehran Stock Exchange and profit conservatism. Considering that institutional investors are not similar to each other and do not have similar motivations for monitoring the adopted procedures by the companies, the relationship between different types of institutional governance and profit conservatism was studied by categorizing institutional investors into active and inactive ones.

Theoretical Framework

Supervisory Role of Institutional Investors

The role of institutional owners and their relationship with profit quality of their possessed companies (including profit conservatism) are unknown and ambiguous. Hassas Yeganeh, Moradi and Eskandar (2008) showed that institutional investors are active supervisors for the decisions and procedures adopted by managers and are authorized to punish managers who do not move along their benefits. Also, Bosch (1998) states that institutional investors implicitly and explicitly monitor the company by gathering information and evaluating management decisions and by governing performance of the company, respectively. Based on the institutional investors' perspectives, the shareholders with relative priority in gathering and processing information are conversant.

Concept of Conservatism

Concept of conservatism has a long-term record in accounting and is one of the most essential characteristics of financial reporting, which has been discussed and played a role in accounting for a long time.

Watts (2003) quoting Bliss (1994) expressed conservatism in an imperative statement to accountants as follows: "Anticipate no profit, but anticipate all losses". Also, Accounting Standards Codification Board (2007) in theoretical concepts of financial reporting has considered conservatism one of the components of "reliability" quality characteristic; but, it uses the word caution instead of conservatism and defines caution as follows: "Caution refers to application of a degree of care which is required in judgment of accounting estimations in ambiguous conditions so that incomes or assets are not shown more than real values and costs or debts are not revealed less than their real amount".

Types of Institutional Ownership (Active and Inactive) and Conservatism

Based on the pieces of evidence obtained from prior studies (like Navissi and Niker (2006), Kornet et al. (2007) and so on), effect of institutional investors on adopted procedures of companies are not similar to each other and they do not have similar motivations for monitoring these procedures. Accordingly, institutional investors can be divided into active and inactive categories. Active institutional investors have long-term perspective and consider long-term performance of the company. Thus, they are motivated to have a representative in board of directors of investable companies. Low turnover of great investors' portfolio indicates their motivation for retaining the stock and encouraging managers to improve performance and increase shareholders' wealth. These shareholders provide motivations for more responsibility of managers through active monitoring of management and their decisions. Almazan et al. (2005) realized that the higher the level of active institutional owners, the more the monitoring level on managers and their adopted procedures would be.

In contrast, inactive institutional investors have high portfolio turnover and follow instant trading strategy. For instance, they buy stock on good news and sell that on bad news. For these owners, the current price of stock is very important; they have a short-term and transient perspective and prefer current performance to long-term performance of the company. Therefore, they do not have much motivation for monitoring management and having a representative in board of directors of investable companies because it is unlikely to take advantage of benefits of this monitoring in a short term. These shareholders' excessive concentration on the current profit and performance might provide motivations for management optimism in presenting accounting profit to achieve their short-term objectives. Thus, it seems that these owners have no interest in using conservative profit procedures.

Research Background

Zeckhauser and Pound (1990) stated that institutional shareholders push companies to pay more stock profit. They prefer paying stock profit to retaining cash because the people within the organization might waste this free cash. In other words, shareholders force the management to distribute more stock profit in order to resist waste of extra cash and decrease representation costs. Therefore, according to this theory, with the increase in institutional ownership, the demand for distribution of stock profit raises.

The results from Bosch (1998) showed that, in companies with less percent of institutional ownership, managers have more tendencies to decrease costs of research and development and, as a result, increase profit to the acceptable year level. In companies where percent of institutional ownership is higher, managers' motivations decrease for profit management through non-investment in research and development activities. Thus, it can be concluded that the presence of institutional owners leads to decreased profit management and consequently conservative accounting.

Bhorraj and Sengupta (2003) found that institutional ownership is positively (negatively) related to ranking (efficiency) of bonds; i.e. the more the concentration of institutional ownership, the more its effect on ranking and efficiency of bonds would be. The results of Bhorraj and Sengupta's studies showed that, although monitoring mechanisms of institutional ownership are considered positive by owners of bonds, concentrated management leads to movement along personal interests.

Noravesh and Ebrahimi Kordlar (2005) studied and explained the relationship of shareholder combination with information symmetry and efficiency of performance

accounting criteria. They chose two samples of investable companies for their experimental test. The first sample included companies with a low degree of institutional shareholder ownership and the second one had companies with a high degree of institutional shareholder owners. Their research results showed that companies in the second group reported more information on future profits than companies in the first group. Thus, more information asymmetry was observed in investable companies with a low degree of institutional shareholders (first group).

Moradi (2007) conducted a research in Tehran Stock Exchange in which the monitoring role of institutional investors was investigated from the perspective of whether institutional ownership had an effect on quality of reported profit or not. Generally, results of this research indicated a positive relationship between institutional investors and profit quality. According to findings of the mentioned research, institutional investors encouraged company managers to report quality profit.

Modares et al. (2009) studied the role of institutional shareholders in stock efficiency based on the 5-year information of 90 companies in Tehran Stock Exchange. Findings of this research showed that, although rate of institutional ownership was very high in companies accepted in Tehran Stock Exchange, there was no significant relationship between institutional shareholders and efficiency. In contrast, according to the results of studies in other countries, this relationship has been positive and sometimes negative.

Hypotheses

Considering the discussed literature about institutional ownership and conservatism, the research hypotheses were as follows:

-First hypothesis: There is a significant relationship between institutional investors and profit conservatism.

-Second hypothesis: There is a significant relationship between active institutional investors and profit conservatism.

-Third hypothesis: There is a significant relationship between inactive institutional investors and profit conservatism.

Methodology of Research

The present research models which were used to study the relationship between institutional ownership and profit conservatism were as follows:

Ball and Shivakumar's Model

Ball and Shivakumar (2005) introduced a model to measure conservatism using the relationship of committed items and cash flows. They used the following regression relationship between committed items and cash flows to show that, in case of the existence of operational losses, correlation of committed items and cash flows would be stronger, which stated a conservative behavior.

$$ACC_{i,t} = \alpha_0 + \beta_1 CFO_{i,t} + \beta_2 DCFO_{i,t} + \beta_3 CFO_{i,t} * DCFO_{i,t}$$

In which:

$ACC_{i,t}$: Subtraction of operational profit from operational cash flow of company i at the end of year t divided by sum of assets at the beginning of the year;

$CFO_{i,t}$: Operational cash flow of company i at the end of year t divided by sum of assets at the beginning of the year;

$DCFO_{i,t}$: is a virtual variable which is 1 for companies with $CFO < 0$; otherwise, it is 0.

In order to evaluate effect of institutional ownership and its types (active and inactive) on conservatism, the mentioned variables were included in the above model:

Ball and Shivakumar's Model – Institutional Ownership

$$ACC_{i,t} = \alpha_0 + \beta_1 CFO_{i,t} + \beta_2 DCFO_{i,t} + \beta_3 CFO_{i,t} * DCFO_{i,t} + \beta_4 INST_{i,t} + \beta_5 INST_{i,t} * CFO_{i,t} + \beta_6 INST_{i,t} * DCFO_{i,t} + \beta_7 INST_{i,t} * CFO_{i,t} * DCFO_{i,t} + \beta_{8-10} CONTROLS_{i,t} + \beta_{11-13} CFO_{i,t} * CONTROLS_{i,t} + \beta_{14-16} DCFO_{i,t} * CONTROLS_{i,t} + \beta_{17-19} CFO_{i,t} * DCFO_{i,t} * CONTROLS_{i,t} + \epsilon$$

(1)

Significantly positive (negative) β_7 shows that, with the increase of institutional ownership, conservatism increases (decreases) in profit reporting.

Ball and Shivakumar's Model – Active and Inactive Institutional Ownership

$$ACC_{i,t} = \alpha_0 + \beta_1 CFO_{i,t} + \beta_2 DCFO_{i,t} + \beta_3 CFO_{i,t} * DCFO_{i,t} + \beta_4 ACINST_{i,t} + \beta_5 ACINST_{i,t} * CFO_{i,t} + \beta_6 ACINST_{i,t} * DCFO_{i,t} + \beta_7 ACINST_{i,t} * CFO_{i,t} * DCFO_{i,t} + \beta_8 INACINST_{i,t} + \beta_9 INACINST_{i,t} * CFO_{i,t} + \beta_{10} INACINST_{i,t} * DCFO_{i,t} + \beta_{11} INACINST_{i,t} * CFO_{i,t} * DCFO_{i,t} + \beta_{12-14} CONTROLS_{i,t} + \beta_{15-17} CFO_{i,t} * CONTROLS_{i,t} + \beta_{18-20} DCFO_{i,t} * CONTROLS_{i,t} + \beta_{21-23} CFO_{i,t} * DCFO_{i,t} * CONTROLS_{i,t} + \epsilon$$

(2)

In Models (1) and (2):

$INST_{i,t}$: Ratio of normal stock provided for institutional owners of company i at the end of year t ;

$ACINST_{i,t}$: Ratio of normal stock provided for active institutional owners (institutional owners with representatives in the board of directors) of company i at the end of year t ;

$INACINST_{i,t}$: Ratio of normal stock provided for inactive institutional owners (institutional owners without representatives in the board of directors) of company i at the end of year t ;

$CONTROLS_{i,t}$: Control variables;

Control variables included:

$BRD-OWN_{i,t}$: Ratio of non-duty managers in board of directors of company i at the end of year t ;

$SIZE_{i,t}$: Size of company i at the end of year t (calculated by natural logarithm of market value of stockowners' rights);

$LEV_{i,t}$: Financial level of company i at the end of year t (calculated by ratio of total debts to total assets);

ϵ : error term (disruption component).

Significantly positive (negative) β_7 shows that, with increase of active institutional ownership, conservatism increases (decreases) in profit reporting. Also, significantly positive (negative) β_{11} demonstrates that, with increase of inactive institutional ownership, conservatism increases (decreases) in profit reporting.

Givoly and Hayn's Model

Givoly and Hayn (2000) presented a method to measure conservatism using committed items. According to this method, constant existence of negative operational committed items during a long-term period in companies is considered a criterion for conservatism.

The model used for studying the relationship between institutional owners and conservatism, after substitution of the research variables, is as follows:

Givoly and Hayn's Model – Institutional Ownership

$$\text{CONSER}_{i,t} = \alpha_0 + \beta_1 \text{INST}_{i,t} + \beta_2 \text{BRD-OWN}_{i,t} + \beta_3 \text{LEV}_{i,t} + \beta_4 \text{SIZE}_{i,t} + \varepsilon_{i,t} \quad (3)$$

$\text{CONSER}_{i,t}$: Conservatism index for company i at the end of year t according to Givoly and Hayn's model is calculated as:

$$\text{Conservatism index} = \frac{\text{Cash flow of the operation} - (\text{Depreciation cost} + \text{Operational profit})}{\text{Sum of assets at the beginning of the period}} \times (-1)$$

Givoly and Hayn's Model – Active and Inactive Institutional Ownership

After including variables of active and inactive institutional investors and also including control variables in the third model, the fourth model is defined as:

$$\text{CONSER}_{i,t} = \alpha_0 + \beta_1 \text{ACINST}_{i,t} + \beta_2 \text{INACINST}_{i,t} + \beta_3 \text{BRD-OWN}_{i,t} + \beta_4 \text{LEV}_{i,t} + \beta_5 \text{SIZE}_{i,t} + \varepsilon_{i,t} \quad (4)$$

In Models (3) and (4), the variables are defined as mentioned previously.

In this research, for each partial regression coefficient, student T statistic was used and Fisher (F) statistic (reliability level of 95%) was applied for testing the significance of regression model.

Population and Statistical Sample

This research was an applied objective-oriented study in terms of research categorization and a descriptive one in terms of methodology categorization. Also, in descriptive studies, it was classified as ex-post facto research (based on past information). In this research, Givoly and Hayn's model (2000) and Ball and Shivakumar's model (2005) were used to measure profit conservatism of companies. Spatial domain of the research included companies accepted in Tehran Stock Exchange. Its time domain was also determined as a 10-year period from 2001 to 2010. Statistical sample of the present research included companies with the following specifications:

1. Financial year of these companies ended in the middle of March.
2. They were accepted in Tehran Stock Exchange prior to 2001.
3. They did not have changes of financial year during the research period.
4. Due to the special nature of company activities, they were not of investing companies, financial intervening ones and banks.
5. All the required information about companies was available during the specified period.

After applying the above limitations, 60 companies were selected as the statistical sample.

Data Analysis

Descriptive Statistics

Table 1. Descriptive statistics of the tested variables

Variable	Minimum	Maximum	Median	Mean	Standard deviation
ACC _{i,t}	-0.790	1.230	0.036	0.043	0.147
CFO _{i,t}	-0.700	0.990	0.158	0.183	0.177
INST _{i,t}	0.090	1.000	0.791	0.759	0.154
BRD-OWN _{i,t}	0.000	1.000	0.600	0.648	0.159
SIZE _{i,t}	9.700	17.150	12.834	13.043	1.349
LEV _{i,t}	0.210	1.030	0.665	0.652	0.151
ACINST _{i,t}	0.000	1.000	0.672	0.651	0.224
INACINST _{i,t}	0.000	0.920	0.050	0.091	0.136
CONSER _{i,t}	-0.400	0.570	0.063	0.068	0.127

It can be inferred from the above table that institutional investors averagely had 75% of the sample companies' stock. Active and inactive institutional investors averagely possessed 65% and 9% of the stock, respectively.

Inferential Statistics

Table 2. Results of the first model (Ball and Shivakumar's model- without separation of institutional ownership)

Model (1) :			
t(p-value)	t-statistic	β	variable
0.009	2.612	0.274	constant
0.003	-2.969	-1.179	CFO _{i,t}
0.001	3.290	0.781	INST _{i,t} *CFO _{i,t} *DCFO _{i,t}
0.010	-2.579	-0.122	LEV _{i,t}
Adj R ² =0.354 R ² =0.374 DW=1.826 0.0001<F(p-value)= F=18.054			

β coefficient and significance level for variable INST_{i,t}*CFO_{i,t}*DCFO_{i,t} were 0.781 and 0.001, respectively (p<0.05). According to the statistically positive coefficient of variable INST_{i,t}*CFO_{i,t}*DCFO_{i,t}, institutional ownership had a positive relationship with conservatism. The calculated F statistic indicated significance of the whole regression model at 99% reliability level. Also, the calculated Durbin-Watson statistic stated that the hypothesis of lack of auto-correlation between the errors was accepted.

Table 3. Results of the third model (Givoly and Hayn's model– without separation of institutional ownership)

:Model(3)			
t(p-value)	t-statistic	β	variable
0.0001<	17.869	1.107	constant
0.0001<	3.829	0.166	INST _{i,t}
0.0001<	-9.138	-0.315	BRD- OWN _{i,t}
0.0001<	-4.550	-0.019	SIZE _{i,t}
0.0001<	3.819	0.142	LEV _{i,t}
0.209Adj R ² =	R ² =0.214	DW=1.841	0.0001<F(p-value)= F=39.408

The resulted F statistic was 39.408 which indicated significance of the whole fitted regression model at 99% reliability level. The calculated Durbin-Watson statistic was 1.841; thus, the theory on the lack of auto-correlation between model errors was accepted. β coefficient for variable INST_{i,t} was positive and equal to 0.166 and significance level was less than 1% for the mentioned variable, which indicated that the mentioned variable was significant and had a positive relationship with conservatism.

Table 4. Results of the second model (Ball and Shivakunar's model- with separation of active and inactive institutional ownership)

Model (2) :			
t(p-value)	t-statistic	β	variable
0.019	2.355	0.247	constant
0.020	-2.338	-0.953	CFO _{i,t}
0.004	2.884	0.600	ACINST _{i,t} *CFO _{i,t} *DCFO _{i,t}
0.023	-2.276	-0.643	INACINST _{i,t} *CFO _{i,t} *DCFO _{i,t}
0.010	-2.575	-0.120	LEV _{i,t}
Adj R ² =0.349	R ² =0.374	DW=1.749	0.0001<F(p-value)= F=14.801

β coefficient for variable ACINST_{i,t}*CFO_{i,t}*DCFO_{i,t} was 0.600. Also, significance level was 0.004 for the mentioned variable which was below 5% error level and indicated that the mentioned variable was significant and had a positive relationship with conservatism. β coefficient for variable INACINST_{i,t}*CFO_{i,t}*DCFO_{i,t} was -0.643. Also, significance level was 0.023 for the mentioned variable, which was below 5% error level and indicated that the mentioned variable was significant and had an inverse relationship with conservatism.

Table 5. Results of the second model (Givoly and Hayn's model - with separation of active and inactive institutional ownership)

Model (4) :			
t(p-value)	t-statistic	β	variable
0.0001<	7.868	0.388	constant
0.0001<	27.913	0.552	ACINST _{i,t}
0.0001<	17.459	0.533	INACINST _{i,t}
0.0001<	-8.408	-0.194	BRD-OWN _{i,t}
0.814	0.236	0.001	SIZE _{i,t}
0.0001<	5.312	0.130	LEV _{i,t}
Adj R ² =0.660	R ² =0.663	DW=1.733	0.0001<F(p-value)= F=226.544

β coefficient for variables ACINST_{i,t} and INACINST_{i,t} was 0.552 and 0.533, respectively. Also, the significance level was below 1% for the mentioned variable, which indicated that the mentioned variables were significant and had a positive relationship with conservatism.

Conclusions

In this research two models by Ball and Shivakumar and also Givoly and Hayn were used to evaluate conservatism. The findings of this research indicated that, in general, there was a positive relationship between institutional investors and profit conservatism in companies accepted in Tehran Stock Exchange. In other terms, institutional investors prevent from opportunist and optimistic behaviors of managers in providing accounting profit and, with increase in their ownership level, tendency of the companies rise in using conservative procedures. These results were in accordance with findings of Chi, Liu and Wang (2009), Ajinkya, Bhorraj and Sengupta (2005) and Bosch (1998).

This positive and direct relationship between active institutional investors (with long-term perspectives) and profit conservatism was found in both models. Therefore, it could be concluded that active institutional investors provide motivation for more responsibility of the management through active monitoring of managers and their decisions and they decrease using conservative procedures for profit management.

The remarkable point here is that in Ball and Shivakumar's model, according to the theoretical fundamentals, an inverse relationship was found between inactive institutional investors and profit conservatism which showed that these owners had no interest in using conservative accounting procedures to monitor managers and their adopted procedures. Instead, this relationship was positive and direct in Givoly and Hayn's method. In other words, despite the thought that inactive institutional owners are not engaged in monitoring the management to demand profit with higher quality, the findings of this model showed that even these owners tended to report profit with higher quality through applying conservative accounting procedures.

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