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Corporate Governance and Conservatism

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Abstract

The purpose of this research is investigating the effects of strong corporate governance mechanisms on financial reporting conservatism of companies listed in Tehran Stock Exchange. Khan and Watts (2009); Givoly and Hayn (2000) models are used as measure of conservatism. Also simultaneously existence of three corporate governance mechanisms are used as determinant of strong corporate governance, these mechanisms are: institutional ownership, CEO/Chair duality and lower percentage of inside directors than the median firm in the sample. The results of investigating a sample of 720 firm-years during the years of 2002 to 2011 of companies listed in Tehran Stock Exchange shows positive and significant relation between corporate governance mechanisms and conservatism. These results confirm complementary approach about the relation between corporate governance mechanisms and conservatism, in other words, strong corporate governance mechanisms increase conservatism in financial reporting.

Keywords: Corporate Governance Mechanisms, Conditional Conservatism, Unconditional Conservatism

Introduction

Conservative financial reporting facilitate efficient contracting between managers and shareholders in the presence of agency problems (Ball, 2001; Watts, 2003) Agency problems between managers and shareholders arise from the separation of ownership and control (Jensen & Meckling, 1976) Corporate governance is concerned with ensuring the firm is run in the interests of shareholders (Allen, 2005). Studies have argued that accounting conservatism is a fundamental feature of quality financial statements (Ball et al., 2000; Ball, 2001; Guay & Verrechia, 2006). Important role of corporate governance and conservative accounting in facilitating efficient contracting causes a link between them. There are two perspectives about the relation between corporate governance and accounting conservatism. The first is complementary perspective that suggests firms with strong corporate governance characteristics are likely to demand more conservatism (Beekes et al., 2004; Ahmed & Duellman, 2007; Lara et al., 2007; Lara et al., 2009a; Ahmed and Henry, 2011). On the other hand, the second is substitutive perspective that suggests the demand for accounting conservatism is higher if financial statements are prepared under weaker corporate governance (Chi *et al.*, 2009). We predict that strong corporate governance structures will favor the implementation of conservative accounting choices, so the research questions are:

1) *What is the effect of strong corporate governance mechanisms on conditional conservatism?*

2) *What is the effect of strong corporate governance mechanisms on unconditional conservatism?*

Literature Review

In this section, we explain about accounting conservatism, conservatism kinds, measures and drivers, and then we explain corporate governance and its mechanisms.

Accounting Conservatism

Conservatism plays an important role in accounting practice and has existed for several centuries. Basu (1997) states that conservatism has influenced accounting practice for more than 500 years. In this section we represent some definitions of accounting conservatism. Conservatism was defined as early as 1924 by Bliss (1924). His definition included “anticipate no profits, but anticipate all losses.” Sterling (1970) rates conservatism as the most influential principle in accounting. Feltham and Ohlson (1995) interpret accounting conservatism as an expectation that reported net assets will be less than market value in the long run. Givoly and Hayn (2000) described conservatism as the choice of accounting principles that lead to a minimization of reported earnings. Conservatism leads to consistently lower cumulative earnings relative to operating cash flows. Beaver and Ryan (2000) explain that accounting conservatism is a persistent difference between market value and book value that is distinct from temporary differences. Watts (2003) defines conservatism as the asymmetry in the verification requirements for gains and losses. A greater degree of verification is required for gains than for losses. Beaver and Ryan (2005) state: “We define accounting conservatism as the on average understatement of the book value of net assets relative to their market value.”

Unconditional and Conditional Conservatism

Accounting conservatism is separated by whether it is unconditional or conditional. Unconditional conservatism is defined as “an accounting bias toward reporting low earnings and book value of stockholders’ equity” (Ball *et al.*, 2008). Unconditional conservatism is referred to as *ex ante* or news-independent conservatism and conditional conservative financial reporting is also known as *ex post* or news-dependent conservatism (Beaver & Ryan, 2005; Ryan, 2006). Beaver and Ryan (2005) define unconditional conservatism as understatement of book value, because of the accounting process, and conditional conservatism is defined as the writing down of assets under adverse conditions but not written up under favorable circumstances. Ball *et al.* (2006) conclude that unconditional conservatism can only reduce contracting efficiency. 2006 state “Conditional conservatism is the stricter concept; imposing the requirement that the accounting bias is conditional on contemporaneous economic income. This requirement is not satisfied by accounting biases such as routinely over-expensing, routinely expensing early or routinely deferring revenue recognition, because their effect on accounting income is not related to economic income.” Conditional conservatism requires a lower degree of verification for bad news than it does for good news, which results in the recognition of bad news in a timelier manner compared to the recognition of good news (Armstrong *et al.*, 2010). Debt contract is among the most important sources of conditional conservatism (Watts, 2003a; Ball *et al.*, 2006).

Beaver and Ryan (2005); Ryan (2006) argue that unconditional form precedes the conditional form of conservatism, because the former is determined at the time assets and

liabilities come into existence, while the latter alters the cost bases of the firm's assets and liabilities after their inception (Beaver & Ryan, 2005). The findings demonstrate that the conditional form of conservatism is negatively related to unconditional conservatism, as the former tends to enhance contracting efficiency, while the latter might facilitate managerial opportunism (Iatridis, 2011).

Determinants of Accounting Conservatism

Contracting, litigation, taxation and regulation are four factors proposed by Watts (2003a) to explain accounting conservatism. There is much evidence in support of the contracting and litigation hypotheses; however, there is little empirical evidence to support the taxation and regulation hypotheses (Watts, 2003b). In this section, we briefly explain these determinants of accounting conservatism.

Contracting Explanation

Watts (2003) suggests that financial statement users benefit from conservative financial reporting and therefore demand it from managers. One explanation of the conservatism demand is the contracting explanation. The contracting explanation of conservatism is that shareholders and debt-holders demand conservative financial reporting from managers to reduce agency costs and to align managerial incentives with those of shareholders. The contracting explanation is comprised of three distinct theories. Watts separates the contracting explanation into the compensation, debt, and governance theories (Blunck & Rego, 2007).

Litigation Explanation

Managers, auditors, and directors are more likely to be sued if earnings are overstated than if they are understated (Watts, 1993, 2003a, 2003b). Asymmetry of litigation costs leads firms to choose conservative accounting to reduce earnings if they are faced with high litigation costs. Chung *et al.* (2003) argued that, to reduce litigation risk, auditors prefer their clients to make conservative (or income-decreasing) accounting choices rather than non-conservative (income-increasing) choices, so managers and auditors have incentives to choose conservative accounting in order to mitigate expected litigation costs.

Taxation Explanation

Asymmetric recognition of losses and gains due to accounting conservatism in financial reporting can affect taxes paid by firms. Profitable firms can reduce or defer their taxes by decreasing their earnings through the use of accounting conservatism. Taxes are affected because of the link between financial reporting and taxation (Watts, 2003a, 2003b).

Regulation Explanation

Standard setters and regulators also favor conservative reporting as this reduces the political costs imposed on them. These bodies are likely to face more criticism if firms overstate their net assets than if they understate them (Watts, 2003).

Qiang (2007) splits each of the conservatism explanations into whether they are due to unconditional or conditional conservatism and provides proxies that can be used for each of the explanations. Specifically, contracting induces conditional conservatism, litigation induces both types, and regulation and taxation are induced by unconditional conservatism.

Conservatism Measures

Watts (2003b) categorize conservatism measures into three groups:

- (1) Earnings and stock returns relation measures;
- (2) Net asset measures; and
- (3) Earnings and accrual measures.

Earnings and Stock Returns Relation Measures

Basu (1997) used a reverse regression of earnings as a function of returns. Basis of his assumption is that positive stock returns generally reflect net asset gains and negative stock returns reflect net asset losses. Basu argued that earnings will reflect net losses more quickly than net gains due to accounting conservatism. This is the asymmetric timeliness of earnings. Despite of widespread use and usefulness of Basu's asymmetric timeliness of earnings measure, latter studies have questioned the validity of Basu's (1997) model because there are economic and econometric limitations of Basu's asymmetric timeliness of earnings, measure of conservatism (Ball *et al.*, 2003; Dietrich *et al.*, 2007; Roychowdhury & Watts, 2007). For example, Dietrich *et al* (2007) argue that regressing earnings on returns leads to results that cannot be interpreted as indicating accounting conservatism, also Givoly & Hayn (2000) argue that Basu made the assumption that a negative stock return equals bad news and a positive equals good news. But sometimes the stock price can move because of the stock market sentiment. This has nothing to do with a good and bad news. Basu does not make a correction for this in his model.

Net Asset Measures

The book-to-market ratio (book value of equity divided by market value of equity of the firm) is a net asset or balance sheet measure. This measure of conservatism, originates from the work of (Feltham and Ohlson, 1995). Pae *et al* (2005) found earnings conservatism, the tendency of firms to recognize bad news in earnings on a timelier basis than good news, is negatively associated with the price-to-book (P/B) ratio (or positively related to the BTM ratio).

Earnings and Accrual Measures

Basu (1997); Watts (1993) predict that negative earnings changes are more likely to reverse in the next period compared to positive earnings changes. Givoly and Hayn (2000) point out that this asymmetric effect on earnings will produce negative skewness in the earnings distribution (Watts, 2003). Givoly & Hayn (2000) expect that when there is conservatism there will be an accumulation of negative accruals in the long-run.

Corporate Governance

There are many definitions of corporate governance in the accounting literature. These definitions can be summarized as follows: corporate governance can be referred to as the set of mechanisms designed to mitigate agency problems that arise between shareholders and managers because of the separation of ownership and control (Jensen, 1993; Shleifer and Vishney, 1997; Armstrong *et al.*, 2010). Corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (John & Senbet, 1998) In other words agency conflicts exist due to the existence of information asymmetries between managers and external capital providers (shareholders and lenders). Corporate governance mechanisms

are designed to mitigate these conflicts (Li et al., 2012). Some of these mechanisms are explained in this section.

Percentage of Outside Directors on the Board

Some authors studied the relation between the proportion of outside directors and financial performance and shareholder wealth (Brickley et al., 1994; Byrd & Hickman, 1992; Rosenstein & Wyatt, 1990) and found significant percentage of outside Directors on the Board causes better stock returns and operating performance. It has been suggested that the board dominance by outside directors may help to alleviate the agency problem by monitoring and controlling the opportunistic behavior of managers (Berle & Means, 1932; Jensen & Meckling, 1976) and such boards may also help in reducing management consumption of perquisites (Brickley & James, 1987). Thus, the domination of insiders on the board may lead to transfer of wealth to managers at the expense of stakeholders (Beasley, 1996).

Institutional Ownership

McConnell and Servaes (1990); Nesbitt (1994); Smith (1996); Guercio and Hawkins (1999); Hartzell and Starks (2003) find that corporate monitoring by institutional investors can constrain managers' behavior because, Large institutional investors have the opportunity, resources, and ability to monitor, discipline, and influence managers.

Separation of CEO and Chairman of the Board

Jensen (1993) argues that separating the positions of chairman of the board and chief executive officer results in greater independence of the board from management. According to the agency theory, separation of duty is necessary for efficient monitoring over the board process (Fama & Jensen, 1983; Jensen, 1993). Absence of this separation causes that the strength of outside director monitoring incentives be compromised as director nomination and election are likely to be influenced by the CEO/Chairman. In such cases, less control is likely to be exercised over management's activities and behaviour (Finkelstein & D'Aveni, 1994). Therefore, he or she is more likely to pursue strategies which advance personal interest to the detriment of the firm as a whole (Jenen & Meckling, 1976). Thus greater monitoring capacity is perceived by the board when the chairman of the board is independent of management.

The Link between Corporate Governance and Conservative Accounting

As we predict that corporate governance provisions result in a higher demand for accounting conservatism, Lobo and Zhou (2006) show an increase in conservatism as a result of the provisions of the Sarbanes-Oxley Act. Also, Beekes *et al* (2004) examines the link between accounting quality, measured by earnings timeliness and earnings conservatism, and the proportion of outside directors on the board. Their results indicate that firms with a higher proportion of outside directors recognize bad news in earnings on a timelier basis. Ahmed and Duellman (2007) suggest that the percentage of inside directors is negatively related to conservatism, and the percentage of outside directors' shareholdings is positively related to conservatism. Lara et al (2007) find that firms with strong boards use conditional conservative accounting as a governance tool.

Research Design

Statistical Population and Sample

In this study the statistical population is all of companies listed in Tehran Stock Exchange during the period of 2002 to 2011(Ten-year period).

We selected a sample of 72 firms according to some conditions such as:

1. The fiscal year-end of the firm is March 20
 2. The firm should not change its fiscal during the research period (2002 to 2011).
 3. This firm is active during the research period and its shares trading are not stopped in any year.
 4. Relevant financial and nonfinancial data about the firm are not missing
 5. The firm should not be a financial or investment one
- With attention to these conditions at end we elect 72 firms as statistical sample.

Research Hypotheses

1) Strong corporate governance mechanisms increase conditional conservatism in financial reporting

2) Strong corporate governance mechanisms increase unconditional conservatism in financial reporting

Research Model

We use following model (1) to test research hypotheses:

$$\text{Con}_{i,t} = \beta_0 + \beta_1 \text{STR. C. G}_{i,t} + \beta_2 \text{MTB}_{i,t} + \beta_3 \text{LEV}_{i,t} + \beta_4 \text{SIZE}_{i,t} + \beta_5 \text{SALE. GR}_{i,t} + \beta_6 \text{CFO}_{i,t} + \beta_7 \sigma \text{REV}_{i,t} + \varepsilon \quad (1)$$

Con = Conservatism, depend on the hypothesis that we want test it, is conditional or unconditional conservatism

STR. C. G = Strong Corporate Governance

MTB = Market value of equity divided by the book value of equity at the end of the fiscal year

LEV = Total liabilities divided by total assets at the end of the fiscal year

SIZE = The natural log of total assets at the end of the fiscal year by including the natural log of average total assets

SALE. GR = The annual percentage growth in total sales

CFO = Cash flows from operations deflated by average total assets

σREV = The standard deviation of the natural log of revenues measured from $t-5$ to year $t-1$

Main model Variables

All of mentioned above variables are explained in details in this section.

Conservatism

We use Khan and Watts (2009) model as a measure of conditional conservatism and also we use two measures of unconditional conservatism in our tests.

a) Conditional Conservatism

Our measure of conditional conservatism is the C-Score, a Basu (1997) type measure developed by Khan and Watts (2009). Basu (1997) shows that earnings have a stronger association with bad news (negative stock returns) than its association with good news

(positive stock returns), that is referred as the asymmetric timeliness of earnings. This property of earnings has been used as a measure of conditional conservatism because a stronger association between earnings and bad news implies that bad news is recognized more quickly than good news. Indeed, Khan and Watts (2009) suggests a firm-year measure of accounting conservatism and the basis of their estimation of the C-Score is the Basu (1997) asymmetric earnings timeliness. They express the timeliness of good news (β_3 or G-score) and the incremental timeliness of bad news (β_4 or C-score) as linear functions of time-varying firm-specific characteristics of the market to book ratio, firm size and leverage which is then substituted into Basu's (1997) model. Then, coefficients that measure the effect of conservatism on market to book ratio, firm size (MV) and leverage are used to estimate the C-Score.

More explicitly, The G-Score and C-Score are estimated as follows:

$$NI_t = \beta_1 + \beta_2 D_t + \beta_3 RET_t + \beta_4 D_t * RET_t + \varepsilon \quad (2)$$

$$G\text{-Score}_t = \beta_3 = \mu_1 + \mu_2 MV_t + \mu_3 MTB_t + \mu_4 LEV_t \quad (3)$$

$$C\text{-Score}_t = \beta_4 = \lambda_1 + \lambda_2 MV_t + \lambda_3 MTB_t + \lambda_4 LEV_t \quad (4)$$

Replacing β_3 and β_4 from equations (3) and (4) into regression equation (2) yields:

$$NI_t = \beta_1 + \beta_2 D_t + RET_t * (\mu_1 + \mu_2 MV_t + \mu_3 MTB_t + \mu_4 LEV_t) + D_t * RET_t * (\lambda_1 + \lambda_2 MV_t + \lambda_3 MTB_t + \lambda_4 LEV_t) + (\delta_1 MV_t + \delta_2 MTB_t + \delta_3 LEV_t + \delta_4 D_t * MV_t + \delta_5 D_t * MTB_t + \delta_6 D_t * LEV_t) + \varepsilon \quad (5)$$

We estimate equation (5) using annual cross-sectional regressions. Consistent with Khan and Watts (2009), we measure NI as net income before extraordinary items scaled by market value of equity at the beginning of the fiscal year, RET as annual return calculated by cumulating monthly returns ending with the fourth month after the fiscal year end, MV as the natural log of the market value of equity at the end of the fiscal year, MTB as market value of equity divided by the book value of equity at the end of the fiscal year t, and LEV is total debt divided by total assets. The estimates from equation (5) are then applied to equation (4) to calculate C-Score.

b) Measures of Unconditional Conservatism

Measures of unconditional conservatism are based on Givoly and Hayn (2000) accrual and earnings measures.

1) Accrual-Based Conservatism (Con-Acc)

Our first measure, Con-Acc, is based on the use of negative accruals following Givoly and Hayn (2000); Ahmed *et al* (2002) and Ahmed and Duellman (2007,2013). The accrual-based measure of conservatism, Con-Acc, is income before extraordinary items less cash flow from operations plus depreciation expense deflated by average total assets, and averaged over the previous three years, multiplied by negative one.

Positive values of Con-Acc indicate greater unconditional conservatism. The intuition underlying this measure is that conservative accounting results in persistently negative accruals (Givoly and Hayn, 2000). The more negative the average accruals over the respective periods, the more conservative the accounting. Averaging over a number of periods also ensures that the effects of any temporary large accruals are mitigated, because accruals tend to reverse within a one to 2-year period (Richardson *et al.*, 2005).

2) *The Skewness-based Conservatism Measure (Skewness)*

Our second unconditional conservatism measure, Skewness, is the difference between cash flow skewness and earnings skewness developed by (Givoly and Hayn, 2000). The skewness of earnings (cash flows) is equal to $(x - \mu)^3/\sigma^3$ where μ and σ are the mean and standard deviation of the earnings (cash flows) over the last five years. All variables are deflated by total assets. This measure has been used in many other studies (e.g., Givoly & Hayn, 2000; Beatty et al., 2008; Louis et al., 2008; Ahmed & Duellman, 2013). A primary feature of conservatism is acceleration in recognition of bad news in earnings and the delayed recognition of good news, which lead to negatively skewed earnings but not cash flows (Basu 1995; Givoly & Hayn, 2000). Larger values of Skewness indicate greater unconditional conservatism.

Strong Corporate Governance

Governance a dichotomous variable set equal to one if the firm simultaneously has three corporate governance mechanisms. More specifically, we classify firm have "strong" corporate governance if the firm meets all of the following three criteria:

- a) A lower percentage of inside directors than the median firm in the sample,
 - b) A higher percentage of institutional ownership than the median firm in the sample,
- and
- c) The positions of CEO and chairman of the board are occupied by different directors

Control Variables

We control for market-to-book (MTB), because Roychowdhury and Watts (2007) find that the asymmetric timeliness is related to the level of conservatism since the inception of the firm. In addition, market-to-book (MTB) captures firms' investment or growth opportunities (Smith & Watts, 1992).

We control for Leverage, because firms with high levels of Leverage tend to have greater bond-holder and shareholder conflicts which in turn have been shown to affect the contractual demand for conservative accounting. Ahmed *et al* (2002) find accounting conservatism mitigates bond-holder and share-holder conflict over dividend policy and reduces firms' cost of debt.

We control for Firm Size, because large firms likely face large political costs that induces them to use more conservative accounting (Watts and Zimmerman, 1986).

We control for Sales Growth, because Ahmed *et al.* (2002) argue that sales growth is likely to affect Con-Acc for two reasons. First, growth in sales will affect accruals such as inventory and receivables, which in turn affects Con-Acc. Second, for firms with declining sales Con-Acc is likely a poor measure of accounting conservatism.

We control for profitability, CFO, because Ahmed *et al* (2002) argue that profitable firms tend to use more conservative accounting.

We control for σ Revenue, operating uncertainty, because greater operating uncertainty increases conflict of interest between bondholders and shareholders over dividend policies and may lead to more conservative accounting (Ahmed *et al.*, 2002)

Results

The descriptive statistics of the main model of testing the hypotheses is shown in Table 1.

Table 1

Descriptive statistics of the study variables

Variables	Mean	Median	Maximum	Minimum	Std. Dev.	Skewness
C-Score	0.312806	0.246375	2.53227	-2.44731	0.385115	0.066509
Con-Acc	-0.064557	-0.05816	0.32357	-0.54575	0.076237	-0.663386
Skewness	0.263443	0.134147	7.36084	-9.81792	1.967132	-0.15717
STR.C.G	0.315493	0	1	0	0.46504	0.794071
MTB	3.491538	2.035185	42.0518	-103.121	6.737265	-3.33366
LEV	0.665253	0.66844	1.71589	0.21467	0.156227	0.362593
SIZE	13.06977	12.7915	18.2014	10.4412	1.36919	1.141458
SALE. GR	0.200407	0.162605	7.68197	-0.67962	0.413016	9.713087
CFO	0.160527	0.13388	0.78887	-0.22322	0.159197	0.918217
σ REV	0.326692	0.30121	1.36145	0.05028	0.168113	2.071439

Table (2) shows the final results of testing the first hypothesis, in other words, we use model (1), that variable (Con) is C-Score that is calculated based on the estimating equation (5) and entering the appropriate coefficient into equation (4).

Table 2

Results of regression of Khan and Watts [2009] C-Score on Str.CG and Control Variables

Variables	Coef.	Std. Err.	z	P>z
Constant	-1.029293	0.137621	-7.48	0.000
STR. C. G	0.0964156	0.0219041	4.4	0.000
MTB	-0.026914	0.0042744	-6.3	0.000
LEV	0.2172691	0.0843049	2.58	0.01
SIZE	0.104417	0.0095801	10.9	0.000
SALE. GR	-0.0012286	0.0276135	-0.04	0.965
CFO	0.2630665	0.1032978	2.55	0.011
σ REV	-0.4356049	0.0618547	-7.04	0.000

Table (3) shows the final results of testing the second hypothesis, in other words, we use model (1), that variable (Con) is Con-Acc or Accrual-Based Conservatism.

Table 3

Results of regression of Accrual-Based Conservatism (Con-Acc) on Str.CG and Control Variables

Variables	Coef.	Std. Err.	z	P>z
Constant	-0.2819824	0.0183612	-15.36	0.000
STR. C. G	0.0076903	0.0033566	2.29	0.022
MTB	-0.0015077	0.0005023	-3	0.003
LEV	0.1000013	0.0134104	7.46	0.000
SIZE	0.0154083	0.0013381	11.51	0.000
SALE. GR	-0.0040084	0.0061736	-0.65	0.516
CFO	0.2287419	0.0177109	12.92	0.000
σ REV	-0.2635633	0.0125576	-20.99	0.000

Table (4) shows the final results of testing the second hypothesis, in other words, we use model (1), that variable (Con) is Skewness or Skewness-based Conservatism measure.

Table 4

Results of regression of the Skewness-based Conservatism Measure (Skewness) on Str.CG and Control Variables

Variables	Coef.	Std. Err.	z	P>z
Constant	-0.2426543	0.6816194	-0.36	0.722
STR. C. G	0.2585614	0.1131895	2.28	0.022
MTB	-0.0723726	0.0153218	-4.72	0.000
LEV	2.089113	0.4724844	4.42	0.000
SIZE	-0.0499178	0.046049	-1.08	0.278
SALE. GR	0.659283	0.1758246	3.75	0.000
CFO	0.9089713	0.5316573	1.71	0.087
σ REV	-0.8859516	0.3216837	-2.75	0.006

The coefficients on STR.C.G is positive in all of tables, furthermore, they are significant at the 5% level, so results show that there is a positive and significant relation between strong corporate governance and conditional and unconditional conservatism and the results confirm the complementary perspective about the relation between corporate governance and accounting conservatism, so first and second hypotheses are confirmed. The coefficient on MTB is negative and significant in all of table, indicating that firms with more growth opportunities use less conservative accounting. The coefficient on leverage is positive and significant in all of tables, consistent with firms with greater bondholder–shareholder conflict demanding greater accounting conservatism. We find a positive and significant coefficient on Size in tables 1 and 2, consistent with larger firms using more conservative accounting as argued by (Watts and Zimmerman, 1986). We find no relation between sales growth (SALE.GR) and conservatism in tables 2 and 3, but positive and significant relation on table 3, also we find a positive and significant relation between cash flows from operation (CFO) and conditional conservatism and first measure of unconditional conservatism, as profitable firms use conservative accounting and there is a negative and significant relation between operating uncertainty (σ Revenue) and conservatism in all of tables.

Conclusion

Agency problems are due to the existence of information asymmetries between managers and shareholders because of the separation of ownership and control. Corporate governance mechanisms are viewed as mitigating the agency conflicts between shareholders and managers. In this research we use Khan and Watts (2009) as measure of conditional conservatism and two accrual and earning measures of Givoly and Hayn (2000) as measures of unconditional conservatism, then we test the effects of strong corporate governance structures on financial reporting conservatism. The results show that firms with strong corporate governance structure will demand greater conservatism, a reason is that conservatism can reduce agency costs, as Watts (2003) argues that conservatism reduces managers' ability and incentives to overstate earnings and net assets by requiring higher verification standards for gain recognition. Our results confirm complementary perspective about the relation between corporate governance and accounting conservatism.

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