

Evaluation of the Conservatism Level in Kuwait Stock Exchange: By Using Basu Model*

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This study aims to evaluate the level of accounting conservatism when preparing financial statements by companies listed in Kuwait Stock Exchange (KSE). In addition, the study examines the factors that affect the level of accounting conservatism in those companies with regard to company sizes, debt contracts, and the type of sector the company belongs to. To achieve these goals, the Basu (1997) model was used to measure conservatism level and the factors influencing it. The sample of the study comprises of 225 companies listed in KSE. Findings of the study showed that the KSE succeeded in forcing Kuwait companies to present a reasonable level of accounting conservatism. The study also found out that the financial statements of small companies were conservative, while those of the big ones were not. In addition, the debt contracts left an impact upon financial reports of accounting conservatism. Thus, companies with lower debts were more conservative than those of higher ones. Moreover, the financial statements of the financial sector in KSE were the most conservative.

Keywords: accounting conservatism, company size, debt contracts, type of sector, financial reporting, Basu (1997) model

Introduction

The need for conservatism appeared together with the Agency Theory (Basu, 1997) to solve the problem that might emerge between managers and stockholders on the separation between management and ownership. Suppose that the financial reports issued by the management were conservative (Ball, 2001; Watts, 2003), stockholders might resort to reduce management salaries to compensate for the difference attributed to the manager's care for their personal interests. To avoid such a situation, managers might resort to present more conservative numbers as an indication of not caring for their personal interests (Watts & Zimmerman, 1983), thus shunning legal responsibility (Givoly & Hayn, 2000). Ahmed and Duellman (2007) found out that accounting conservatism helps reduce agency costs. Finally, Hamdan (2011) found that accounting conservatism contributes to the improvement of quality of financial reporting through an external auditor for clean opinion. This study helps in establishing a relationship between the high level of accounting conservatism in Jordanian industrial companies and the improvement of the opinion of external auditor. As for the role of accounting conservatism in improving the efficiency of debt contracts, studies of the last period ascertained that

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accounting conservatism helped in improving the efficiency of the debt contracts by increasing the ability of accounting information to predict the future. (Watts, 2003; Ball & Shivakumar, 2005; Ball, Robin, & Sadka, 2008). Accounting conservatism secures, for the debtors, more strict policies in declaring profits and consequently limits profit distribution as this provides the company with a better opportunity to meet its liabilities. But Gigler, Kanodia, and Sapra (2009) saw that accounting conservatism reduces the efficiency of debt contracts because it changes the content of accounting, thus reducing the possibility of future prediction. The significance of this study stems from being the first to measure the level of accounting conservatism in the financial statements issued by companies listed in KSE and the factors that affect it. In search for the factors influencing the level of accounting conservatism, many studies considered the distinction between companies regarding accounting conservatism in their financial reports. Hamdan (2010) and Yaseen (2008) found out that banks were the most conservative in their accounting policies. But Al-Sehli (2009) disagreed with them as he found that the banking sector in Saudi Arabia was the least conservative in its accounting policies. As for the relation between the size of company and accounting conservation, Hamdan, (2010) found that big companies adopt conservative accounting policies to avoid political costs, but Al-Sehli (2009) did not find any relation between the size of the company and the degree of accounting conservatism. Contrary to what expected, Hamdan (2010) found that the low-debt companies were the most conservative in their accounting policies. Al-Sehli's (2009) study did not find any effect of debt size on accounting conservatism, but found that establishing Saudi Stock Exchange had an effect on accounting conservatism in financial reporting and that agreed with what the study of Labo and Zhou (2006) reached at. The demands of U.S. Securities Exchange Commission helped in increasing accounting conservatism in financial reporting. The accounting conservatism also helps in Quality Disclosure (Paprocki & Stone, 2004; Yaseen, 2008). Accounting conservatism also plays a role in Earnings Quality, being continuous (Penman & Zhang, 2002). The Sarbanes-Oxley act is considered the most important legislation in reinforcing corporate governance which helps increase accounting conservatism (Labo & Zhou, 2006). This was ascertained by the study of Lara, Osma, and Penalva (2007), which found that corporate governance helped increase accounting conservatism. Krishnan and Visvanathan (2007) discovered that experience of the Audit Committee, one of the pillars of corporate governance, affected the degree of accounting conservatism. Yaseen (2008) did not find any influence of the corporate governance on the relation between accounting conservatism and the improvement of quality of disclosure. Accounting conservatism is one of the active tools in the corporate governance which managers can use to improve the level of corporate governance in the company (Lara et al., 2007). This study differs from previous studies in being the first to measure accounting conservatism in the financial statements issued by public-joint companies listed in KSE, using Basu (1997) model. Thus, it tries to discover the factors affecting the level of accounting conservatism in these companies. The study is expected to present important information for decision makers and regulators of accounting profession in Kuwait.

Research Methodology, Sample and Hypothesis Development

Basu (1997) model will be adopted here. It is based on the fact that accountants usually tend to admit unrealized losses before the unrealized earnings (Al-Sehli, 2009). The present realized earnings which include future losses, not the earnings expected to be more sensitive to the bad news than the good ones (Basu, 1997). This means that conservatism did not allow simultaneous admissions of economic events when reporting earnings (Yaseen, 2008) because bad news will be more effective on earnings than good ones. It is then

expected that earnings will be more related to stock trading through the period of bad news than the good ones. Thus, conservatism measurement is the difference between stock trading and earnings' indicator during the period of bad news and its relation to periods of good news (Givoly & Hayn, 2000). Basu's (1997) model used reverse regression for the earnings $X_{i,t}$ divided by closure share price at the end of last year ($P_{i,t-1}$) on the return $R_{i,t}$ according to the following regression model:

$$X_{i,t} / P_{i,t-1} = \alpha_0 + \alpha_1 DR_{i,t} + \beta_0 R_{i,t} + \beta_1 (R_{i,t} \times DR_{i,t}) \quad (1)$$

where,

$X_{i,t}$: Means earnings per share of the company i , during period t .

$P_{i,t-1}$: Share price of the company i , at the beginning of period t or closure of the year $t-1$.

$R_{i,t}$: Returns (net income) of the company i during period t .

$DR_{i,t}$: Dummy variable which equals 1 if $R_{i,t}$ is less than zero (net loss) and equals 0 if $R_{i,t}$ is more than zero (net profit).

The study sample included all the companies listed in KSE, the sample comprises of the 225 companies, which published their financial statements for the year of 2009.

Hypothesis Development and Methodology

The study posed four null hypotheses are the following:

H1: There is no acceptable level of accounting conservation in financial statements issued by the companies listed in KSE.

Basu (1997) model will be used to test the first hypothesis whose goal is to measure the level of accounting conservatism as parameters of this model are assessed. If the R-squared is higher regarding the negative return ($R_{i,t} < 0$) which represents bad news—expected loss—than the positive return ($R_{i,t} > 0$) which represents good news, then the earnings are more in concurrence with bad news (Al-Sehli, 2009). Then, financial reports will eventually be more conservative, for earnings are more sensitive to bad news, than good ones, then the (β) will be higher for the negative earning than the positive one (Basu, 1997). Therefore, the presence of a suitable level of accounting conservatism means that the variable ($R_{i,t} \times DR_{i,t}$) will be statistically important in the model of Basu (1997).

H2: There is no statistically significant impact of the company size on the level of accounting conservation in the financial statements issued by the companies listed in KSE.

The aim of the second hypothesis is to measure the influence of the company size on the level of accounting conservatism. In other words, it tries to test what past studies concluded that big companies are more conservative than the small ones. It also tries to know how to use Basu (1997) model in measuring the effect of size on the level of conservatism. The mean of total assets of all the companies was taken as well. If the total assets of the company through the study period were more than the general mean, the company was then considered big, but less than that, it was then considered of small size. The number of big companies was 58 and the number of small ones 167. Afterwards, Basu (1997) model would be used to evaluate big and small companies individually. To measure the degree of conservatism of any company, the ($R_{i,t} \times DR_{i,t}$) should be statistically significant. To compare big companies with small ones regarding conservatism, the Adjusted R^2 used in comparing models should be considered. The higher this parameter was, the higher the degree of accounting conservatism would be.

H3: There is no statistically significant impact of the debt contracts on the level of accounting conservation in the financial statements issued by the companies listed in KSE.

Several past studies examined the influence of debt contracts on the level of accounting conservatism in

financial reports and whether or not the debtors could force the company to have a high level of conservatism in its financial reports. This is what the third hypothesis of this study aims at. To use Basu (1997) model in measuring the influence of debt contracts on the level of conservatism, the study used the financial leverage in considering the 225 company sample for the year of 2009 by dividing the total liabilities of the company on the shareholders' equity. Afterwards, the mean of financial leverage for all companies was taken into consideration. If the financial leverage of the company through the period of study was found to be more than the general average, then the company was regarded a high-debt one, less than that a low-debt one. The high debt companies were 113 and the low-debt ones 112. After classifying sample companies with regard to debt size, Basu (1997) model will be used to evaluate every category comparing all, with reference to the decision previously taken.

H4: The economic sectors listed in KSE are similar, with regard to the level of conservatism, in their financial statements.

The fourth hypothesis examines the impact of the type of the sector of the company on the level of conservatism in its financial statements. There are seven sectors in KSE which are: banks, investment, insurance, real estate, industrial, service, and food. To get along with past studies and to make comparison easier, companies were divided into three sectors: financial (including banks, investments, and insurance), industrial (including industrial, real estate and food), and finally, the services sector. The number of the companies in the financial sector was 77, services 60, and industrial the biggest among them was 88. After classifying the sample companies from the economic sectors, Basu (1997) model would be used to assess every sector and then compare them all, with reference to the decision taken previously.

Discussion of Findings and Conclusions

We measured the level of accounting conservatism in the financial statements of all Kuwait companies through using the Basu (1997) model (Table 4). It was clear from the results that the financial statements issued by those companies were conservative. Such a result did not agree with the results of past studies that conducted in similar environments, like the study of Hamdan (2010), which disclosed that the financial reports of Jordanian companies never had accounting conservatism. So did Al-Sehli's (2009) study which also showed that Saudi companies never presented any accounting conservatism when preparing financial results. Many studies were conducted in other environments (Ball, Robin, & Sadka, 2008). Accounting conservatism in KSE showed an increasing demand for: accounting information in KSE, more powerful censorship by owners, more financial analysts, and more governmental bodies.

Table 1

The Effect of Corporations Size on Accounting Conservatism Using Basu Model

Variable	Big corporations ($n = 58$)			Small corporations ($n = 167$)		
	Coefficient (β)	t -Statistic	p -value	Coefficient (β)	t -Statistic	p -value
$DR_{i,t}$	-0.262	-5.210	0.000	-0.355	-5.763	0.000
$R_{i,t}$	0.000	3.893	0.000	0.000	0.636	0.526
$R_{i,t} \times DR_{i,t}$	0.000	0.258	0.797	0.000	-2.432	0.016
<i>Adjusted R</i> ²	0.213			0.446		

Table 2

The Effect of Debt Contracts on Accounting Conservatism Using Basu Model

Variable	High financial leverage ($n = 113$)			Low financial leverage ($n = 112$)		
	Coefficient (β)	t -Statistic	p -value	Coefficient (β)	t -Statistic	p -value
$DR_{i,t}$	-0.325	-8.429	0.000	-0.388	-3.628	0.001
$R_{i,t}$	0.000	1.504	0.136	0.000	-2.981	0.004
$R_{i,t} \times DR_{i,t}$	0.000	-0.285	0.776	0.000	-2.008	0.048
Adjusted R^2	0.154			0.417		

Table 3

The Effect of Sector Type on Accounting Conservatism Using Basu Model

Variable	Financial sector ($n = 77$)		
	Coefficient (β)	t -Statistic	p -value
$DR_{i,t}$	-0.371	-4.232	0.000
$R_{i,t}$	0.000	0.474	0.637
$R_{i,t} \times DR_{i,t}$	0.003	3.595	0.001
Adjusted R^2	0.211		
Variable	Services sector ($n = 60$)		
	Coefficient (β)	t -Statistic	p -value
$DR_{i,t}$	-0.211	-4.959	0.000
$R_{i,t}$	0.000	-3.149	0.003
$R_{i,t} \times DR_{i,t}$	0.000	-1.307	0.197
Adjusted R^2	0.455		
Variable	Industrial sector ($n = 88$)		
	Coefficient (β)	t -Statistic	p -value
$DR_{i,t}$	-0.285	-6.074	0.000
$R_{i,t}$	0.000	-2.683	0.009
$R_{i,t} \times DR_{i,t}$	0.000	-1.711	0.091
Adjusted R^2	0.425		

Table 4

Basu Model for All Corporations

Variable	Coefficient (β)	t -Statistic	p -value
$DR_{i,t}$	-0.348	-6.913	0.000
$R_{i,t}$	0.000	3.238	0.001
$R_{i,t} \times DR_{i,t}$	0.000	-3.280	0.001
Adjusted R^2	0.247		

Regarding the influence of company size on the level of accounting conservatism, Table 1 shows testing of the second hypothesis. It was obvious that the company size had an influence on the level of accounting conservatism (i.e., the financial statements of the small companies were more conservative than those of the big ones). Despite the fact that large companies should be even more conservatism, in order to avoid the political costs that might emerge from disclosing great earnings or values of big assets and to avoid the increasing censorship of government, financial analysts, and the more governance over them than over the small companies. This result does not agree with the study of Hamdan (2010), which proved the influence of the size on the level of conservatism in Jordanian companies, and showed that the large companies are more conservatism. Regarding the influence of debt contracts on the level of accounting conservatism in the financial

statements of the Kuwaiti company, from Table 2, it was clear that the debt contracts had an influence on the level of accounting conservatism (i.e., the financial statements of the low debts companies were more conservative than those of the high debts companies). This result agrees with Hamdan's (2010) study which found out that debt contracts had an effect on the level of accounting conservatism, and agreed with it in that companies of low debts in Kuwait were more conservative, as well as Hamdan's revealed that the low-debt companies in Jordan were more conservative. Al-Sahli's (2009) study did not find any influence of debt on the level of accounting conservatism in the Saudi corporations. Finally, in the fourth hypothesis, the economic sectors in KSE were put into comparison regarding the level of accounting conservatism (Table 3). The financial sector was found to be more conservative than the services and industrial. The findings of this study reflect the success of KSE in obliging the companies to present a reasonable level of accounting conservatism. The regulating and supervising authorities should force these companies to increase their commitment to accounting conservatism and to force, as well, the other sectors to have a reasonable level of conservatism.

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