

Factors Influencing the Level of Accounting Conservatism in the Financial Statements

Allam Mohammed Mousa Hamdan (Assistant Professor)

Department of Accounting, College of Business and Finance, Ahlia University

P.O. Box: 10878 Manama, Kingdom of Bahrain

E-mail: ahamdan@ahliauniversity.edu.bh

Mohammed Hasan Abzakh (Assistant Professor)

Department of Accounting, College of Business and Finance, Philadelphia University

P.O. Box: 1 Amman 19392, Kingdom of Jordan

E-mail: abzakh1973@yahoo.com

Mahmud Hosni Al-Ataibi (Assistant Professor)

Department of Investment and Financing, College of Administrative and Financial Sciences, Taif University

P.O. Box: 888 Zip Code 21974 Taif, Al-Haweah, Kingdom of Saudi Arabia

E-mail: alataibi_m1964@yahoo.com

Received: February 10, 2011 Accepted: May 16, 2011 doi:10.5539/ibr.v4n3p145

Abstract

This study aims to evaluate the role of the public sector in regulating Accounting Standards in Kuwait through examining its ability to oblige those companies listed on the Kuwait Stock Exchange (KSE) to present a reasonable level of accounting conservatism when preparing financial statements. In addition, the study examines the factors that affect the level of accounting conservatism in those companies with regard to company size, debt contracts, and the type of sector the company belongs to. To achieve these goals, two different methods were used to measure conservatism level and the factors influencing it. The methods are: Basu (1997) model and Book-to-Market approach. The sample of the study comprises of (225) companies listed on the (KSE). Findings of the study showed that the public sector of regulating accounting standards 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 Kuwait Stock Exchange were the most conservative. The findings of the study showed how significant the accounting information in Kuwait was.

Keywords: Accounting conservatism, Financial statements, Kuwait stock exchange

1. Introduction

The accounting conservatism concept was controversial at the turn of last century and is still until now. Despite the critiques against this principle, it still plays an important role in accounting practices (Watts, 2003a). Today, in the middle of the waves of skepticism regarding financial reports, adherence to this principle became a distinguishing aspect for companies with reference to the transparency of their financial reports and a standard for classifying countries according to adherence to accounting principles (Hamdan, 2010) and conservatism, which disclose the expected losses aside from the anticipated earnings, in addition to the lowest values of assets. Accounting conservatism implies using strict standards when declaring profits (LaFond & Roychowdhury, 2008). This should not lead to undervaluing of assets or income (IASB framework, paragraph 37). Some of the benefits of Accounting Conservatism of financial lists are: reducing opportunist motives for managers when disclosing optimistic results, increasing contracts control, and reducing court costs (Watts 2003a, b; Ball & Shivakumar 2005). The need for accounting conservatism is related to the increase of credibility in accounting information (Hellman, 2008), as conservatism of declaring good results of the company increases accounting credibility and the ability to predict the future. This study tries to measure the level of conservatism in the financial reports of the companies listed on the

Kuwait Stock Exchange (henceforth KSE), thus evaluating the public sector method in regulating accounting standards in the country. Measuring the accounting conservatism in (KSE) helps in measuring the efficiency of this emerging market. Some studies indicate that the Efficient Market Hypothesis (EMH) is achieved through the conservative financial reports issued by any company, as the stock price reflects all the information available at the suitable time (Yaseen, 2008). The problem discussed in this study is exemplified through answering the following questions: What is the level of accounting conservatism in the financial statements issued by the companies listed on the (KSE)? What are the factors that affect the level of this conservatism? 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 on the (KSE) and the factors that affect it. Through this, the study evaluates the regulation method of the public accounting sector in Kuwait and to what extent it can oblige companies to have a reasonable level of accounting conservatism. It also evaluates the efficiency of the (KSE). 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 management were conservative (Ball, 2001; Watts, 2003), stockholders might resort to reducing management salaries to company fate for the difference attributed to the manager's care for their personal interests. To avoid such a situation, managers might resort to presenting more conservative numbers as an indication of not caring for their personal interests (Watts & Zimmerman, 1983), thus shunning legal responsibility (Givoly & Hayn, 2000). Ahmed & Duellman, (2007) found 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 a 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 accounting conservatism helped in improving the efficiency of the debt contracts by increasing the ability of accounting information to predict the future (Watts, 2003a; Ball and Shivakumar, 2005; Ball et al., 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 et al., (2009) see that accounting conservatism reduces the efficiency of debt contracts because it changes the content of accounting, thus reducing the possibility of future prediction. 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 that banks are the most conservative in their accounting policies. But Al-Sahli (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-Sahli (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-Sahli'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 & Zhou, (2006) reached at. The demands of US Securities and 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 et al., (2009) which found that corporate governance helped increase accounting conservatism. Krishnan & 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 on the (KSE), using two different methods. 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 the accounting profession in Kuwait.

2. Research Methodology

Several methodologies were used in measuring the level of conservatism in financial statements. Despite the difference of the results reached at sometimes by these methodologies, they all depended on the heterogeneous effect on returns and losses in financial reports, specifically the net assets profits and accruals (Yaseen, 2008). As

this study uses two different methodologies in measuring accounting conservatism and the factors influencing it, the results obtained are more accurate. The first method is based on Basu, 1997 model known by some as Earnings Stock Returns Relation Measures. The second method is based on Book-to-Market Ratio.

2.1. Research Sample

The study sample included all the companies listed on the (KSE), the sample comprises of the (225). Which published their financial statements for year of 2009. The sample-selection procedure is summarized in Table (1).

2.2. Research Hypothesis

The study posed four null hypotheses, the first of which aims at measuring the level of accounting conservatism in the financial statements issued by the companies listed on the (KSE). The other three hypotheses aim at measuring the factors influencing the level of accounting conservatism. The hypotheses are the following:

H₀₁: There is no acceptable level of accounting conservation in financial statements issued by the companies listed on the (KSE).

H₀₂: 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 on the (KSE).

H₀₃: 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 on the (KSE).

H₀₄: The economic sectors listed on the (KSE) are similar, with regard to the level of conservatism, in their financial statements.

2.3. Study Models

The study used two different methods in measuring conservatism and the factors influencing it. Thus, the Basu 1997 model was the first model to be used, but the second method is the one that depends on the market in measuring accounting conservatism. These methods are:

2.3.1. The First Method

The 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-Sahli, 2009). The present realized earnings, which include future losses, not the earnings expected to be more sensitive to 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 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 uses 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 (0) if ($R_{i,t}$) is more than zero (net profit)

Using Basu Model in Testing the First Hypothesis: Level of Accounting Conservatism

This 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-Sahli, 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).

Using Basu Model in Testing the Second Hypothesis: The Influence of Company Size on the Level of Accounting Conservatism

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 was more than the general Mean, the company was then considered big, but less than that 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-squared used in comparing models should be considered. The higher this parameter was, the higher the degree of accounting conservatism would be.

Using Basu Model in Testing the Third Hypothesis: The Influence of Debt Contracts on Accounting Conservatism

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 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.

Using Basu Model in Testing the Fourth Hypothesis: Discrepancy between Economic Sectors in the Level of Accounting Conservatism

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 were (77), Services (60), and Industrial the biggest among them were (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.

2.3.2. The Second Method

To ensure the results reached at through using Basu, 1997 model, the study used a different model to measure the level of conservatism in financial statements and the factors influencing it. The model is:

Book-to-Market Approach for Testing the Level of Accounting Conservatism

Contrary to Basu 1997 model of accounting conservatism, many studies referred to the book-to-Market (BTM) as one of the indicators of accounting conservatism. The theoretical frame developed by Beaver & Ryan (2000), used by few studies like those of (Ahmed & Duellman, 2007; LaFond & Roychowdhury, 2007; Jain & Rezaee, 2004; Ahmed et al., 2002; Givoly & Hayn, 2000) proposed using (BTM) to measure conservatism. The Book-to-Market ratio value is used to test share value in comparison with the market value. The book value is gotten through dividing (total equity deducted from outstanding shares) on the average weighted of the number of outstanding shares. The market value is the closing price of the share at the end of the year.

Testing the first hypothesis using the Book-to-Market Approach will be gotten through considering the difference between the book and market values using the Parametric Independent Sample t-test and Non-Parametric Mann-Whitney test. If the parameter of this test was negative with a statistical significance, that meant the book value was less than the market's during an incessant period of time. Such a thing reflected the use of prejudiced accounting policies which hastened admitting expenses and loss, but delayed admitting incomes and returns. Beaver & Ryan, (2005); Jain & Rezaee, (2004) noted that reducing the ratio of book value to less than one compared to the market value refers to a reasonable level of accounting conservatism in the financial report.

Testing Factors Influencing the Degree of Accounting Conservatism Using the Book-to-Market Approach

The second method of testing the factors influencing the level of accounting conservatism is evaluated through the size Regression Method, debt, and type of sector compared to the Book-to-Market value as the following regression method shows:

$$BTM_{i,t} = \beta_0 + \beta_1 Size_{i,t} + \beta_2 Leverage_{i,t} + \beta_3 Sector_{i,t} + \ell_{i,t} \quad (2)$$

Where:

$BTM_{i,t}$: Dependent variable, Book-to-Market ratio as an indicator of the level of accounting conservatism of company (i) in the year (t).

β_0 : Constant value.

$\beta_{1..3}$: Slope value of independent variable.

$Size_{i,t}$: First independent variable, company size (i) natural log of total assets in the year (t).

$Leverage_{i,t}$: Second independent variable, financial leverage (Total debt/total assets) as an indicator of the size of the company's debt (i) (debt contracts) in the year (t).

$Sector_{i,t}$: The third independent variable, the company sector (i) in the year (t) it is dummy variable, (1) if the company belongs to financial sector, (2) if it belongs to industrial sector, (3) if it belongs to service sector.

$\ell_{i,t}$: Random error.

3. Data Analysis and Hypotheses Testing

This item includes two major parts: the first is concerned with the validity of the data for statistical analysis. The second tests the study hypotheses.

3.1. Testing Data Validity

Models of this study belong to General Linear Model (GLM) that requires many conditions before being practiced. Therefore, data of this study must be tested to make sure that they meet the conditions of the general linear model. What follows is testing data credibility for statistical analysis. Table (2) shows the necessary tests needed to test data validity of statistical analysis. To secure approximation of data to normal distribution, Jarque Bera parametric test was used. The decision basis was to accept the null hypothesis that the data follow normal distribution if the probability of (J-B) test was more than 0.05 (Gujarati, 2003). From part (A) table (2), we notice that the (J-B) probability for all variables of the two models, first and second, was less than 0.05; that implies it was far away from normal distribution. What reinforces this result is the Skewness which was not close to zero and Kurtosis which was not close to (3). This ascertains that the study data are not close to normal distribution. To overcome this problem, natural logarithm for these variables was considered. Because the size of the sample was big, not distributing the data normally may not influence credibility of the study. The strength of the General Linear Model (GLM) basically depends on the hypothesis that every variable from the independent ones is by itself independent. If this condition is not realized, the general linear model will then be inapplicable. It can never be considered good for parameters' evaluation (Sifo & Mishal, 2003). To actualize this, Collinearity Diagnostics Standard used incessant Tolerance quotient for every variable of the independent ones. Variance Inflation Factor (VIF) has to be found afterwards. This test is the standard that measures the effect of independent variables. Gujarati, (2003) stated that getting a (VIF) higher than (10) indicates that there is a Multicollinearity problem for the independent variable of concern. From part (B) table (2) one can notice that the (VIF) value for all independent variables is less than (10) which means that we do not have any Collinearity problem in the models of the study. The autocorrelation problem in the model emerges when the two neighboring scenes are correlated and that influences the credibility of the model. The influence of the independent variables will be great, due to that correlation. To verify that, Durbin Watson (D-W) test was used. Part (C) in table (2) model shows that the (D-W) value of the two models is beyond the d -Statistic range which is less than the minimal range d_L . This indicates the presence of a positive autocorrelation between these two models (Gujarati, 2003). To overcome this problem (Lag1) has to be considered when testing models of the study. One of the significant assumptions of the classical regression models and implementation of the Ordinary Least Square (OLS) is the actual presence of Homoskedasticity. Besides, its Mean should be equal to zero (Awad, 2000). If the Heteroskedasticity is present in the model, then some statistical methods will be used to overcome this problem, like using (White) test which is routinely conducted, using (E-Views) program after being elicited from the program themselves. From part (C) of table (2), we find that p -value of the two models is more than (0.05) which indicates admitting the null hypothesis. This model suffers from actual Heteroskedasticity, but the problem was overcome by using (White).

3.2. Testing Hypotheses

After securing the validity of data for statistical analyses, testing study models became possible. The level of accounting conservatism in the financial statements issued by companies listed on the (KSE) was measured, adopting two different approaches. The factors influencing this conservatism were studied as well.

3.2.1. Testing the First Hypothesis

The level of accounting will be measured through the Basu, 1997 evaluation model. To ensure that the Book-to-Market approach was used. Part (A) in table (3) shows testing of the first hypothesis.

Using Basu Model to Measure the Level of Accounting Conservatism

Testing the presence of conservatism in the financial statements of the companies is measured through earnings which include bad news (negative return). This means that the variable ($R_{i,t} \times DR_{i,t}$) in (Basu model) should be statistically significant. In part (A) of table (3) we find that the variable ($R_{i,t}$ return) in the model has statistical significance (t -Statistic $>$ t -Critical and p -value $<$ 0.05) This means that net earnings of the company affect the share price. Thus, accounting information plays role in (KSE). When the first null hypothesis was tested, it was found that the financial statements of companies listed on the (KSE) showed no conservatism. This could be arithmetically expressed as follows: ($H_0: \beta_2=0$) for the substitution hypothesis ($H_a: \beta_2 \neq 0$), the (β) of the variable ($R_{i,t} \times DR_{i,t}$) is statistically significant when the (t -Statistic) is more than its critical value and the probability (p -value) is less than (0.05). Therefore, we reject the null hypothesis and accept the alternative one instead. Thus, we might say that the financial statements issued by the companies listed on the (KSE) are conservative.

Measuring Accounting Conservatism using BTM Approach

The second approach of measuring the level of accounting conservatism in the financial statements issued by companies listed on the (KSE) is (BTM) ratio. The presence of a reasonable level of accounting conservatism means that the Book Value (BV) is less than that of the Market Value (MV) through a certain period of time. This indicates that certain accounting policies were used and those were biased in admitting loss and lower values of the assets. The company would be eventually evaluated less than its real value which might be evaluated higher in the market as the following formula ($BV-MV < 0$) shows. By testing the null hypothesis according to which there is no reasonable level of accounting conservatism as expressed in the following ($H_0: BV-MV \geq 0$) in opposition to the alternative hypothesis according to which there is a reasonable level of conservatism. The book value is less than that of the market and this is explained as follows ($H_1: BV-MV < 0$). In testing this hypothesis, two kinds of tests were used: the parametric and the non-parametric. The rule of having a reasonable level of conservatism stipulates that the outcome of these tests must be negative with statistical significance. From part (B) table (3), we notice that the t -Statistic of the Independent Sample t -Test was negative with statistical significance. The z -Statistic of the non-parametric, White Mann-Whitney test was also negative but not statistical significance of two levels 5% and 1%. This means that the parametric and the non-parametric test results not reinforce each other in the approach of BTM. It also indicates that there is a reasonable level of accounting in the financial reports issued by the companies listed on the (KSE). The results of this approach consolidate those reached at by using Basu model.

3.2.2. Testing the Second Hypothesis

The second hypothesis is concerned with examining the influence of company size on the level of accounting conservatism in its financial statements. The hypothesis was tested by using two different approaches: the first was the Basu 1997 model and the second was based on size regression company size on (BTM) ratio. To examine the effect of company size on the level of accounting conservatism using Basu model, it was assessed for both big and small companies divided according to the size of their assets. The results were presented in table (4) part (A). The table shows that the variable ($R_{i,t} \times DR_{i,t}$) in the model of big companies was not statistical significance. Such a thing reflected the presence of a low level of accounting conservatism in the big companies of (KSE). This is viewed from the perspective that big companies not adhere to conservatism in preparing their financial reports in order to avoid political costs, governmental alertness, financial analysts, and high level control of the corporate governance. As for the small companies, he results were presented in part (A). The part shows that the variable ($R_{i,t} \times DR_{i,t}$) in the model of small companies was with statistical significance. Such a thing reflected the presence of a reasonable level of accounting conservatism in the small companies unlike big companies. As a result, the alternative hypothesis is accepted while the null hypothesis is rejected. Generally speaking, the size of the company affects the level of accounting conservatism when preparing financial statements. The small companies are more conservative than the big ones. This reinforces the formula that Adjusted R^2 is bigger in models of small companies than in big ones. To certify the test results of the company size on the level of accounting conservatism the regression model of company size on, the Book-to-Market ratio was assessed. From table (5) the size variable (β_1) was positive which shows the reversal relation between the level of accounting conservatism and company size. This variable has statistical significance at level 5% or 1%. Consequently, the size of the company had influence on the level of accounting conservatism. The results reached at through using the (BTM) approach agree with those of the Basu 1997 model, the small companies are more conservative than the big ones.

3.2.3. Testing the Third Hypothesis

In the third hypothesis, we examine the influence of debt contracts on the level of accounting conservatism and question whether the more in debt companies are more conservative. In part (B) table (4) we notice that the companies of more financial leverage are not conservative regarding the financial statements issued by them, as the variable ($R_{i,t} \times DR_{i,t}$) has no statistical significance. The financial statements of the less financial leverage companies

are characterized by accounting conservatism, as the variable ($R_{i,t} \times DR_{i,t}$) shows a statistical significance. It seems that the companies of less debts were more conservative for the Adjusted R^2 of companies with lower debts was more than that of higher in-debt ones. To assure the influence of debt on the level of accounting conservatism, the regression of financial Leverage on the (BTM) value was assessed. From table (5) we notice that (β_2) of the financial leverage variable was positive. This shows that there is a negative relation between the level of accounting conservatism and size of the debt of the company. This variable was of statistical significance at level 5% and 1%. Thus, there is an influence of the debt contracts on the level of accounting conservatism, as companies of lower debts are more conservative. The results reached at through using the (BTM) approach agree with those of the Basu 1997 model. Consequently, we might reject the null hypothesis and accept the alternative hypothesis instead. The size of company debt “debt contracts” affects the level of accounting conservatism of that company. The financial statements of companies with lower debts were more conservative.

3.2.4. Testing the Fourth Hypothesis

The aim of this hypothesis is to know the difference in the economic sectors in (KSE) regarding the level of accounting conservatism in their financial statements. The sectors, therefore, are divided into three types: financial sector, industrial sector, and service sector. The hypothesis then is tested using Basu 1997 model and the (BTM) approach. The results were as follows: The Basu 1997 model in the three sectors in (KSE) was evaluated. The results are presented in table (6). From this table, one could notice that the (77) financial sector companies were distinguished for their reports which showed accounting conservatism, as the variable ($R_{i,t} \times DR_{i,t}$) shows a statistical significance (t -Statistic $>$ t -Critical and p -value $<$ 0.05). But we notice that the companies of services and industrial sectors are not conservative regarding the financial statements issued by them, as the variable ($R_{i,t} \times DR_{i,t}$) has no statistical significance. We also noticed that the financial reports of the service companies were more conservative than those of the industrial sector companies because the adjusted (R^2) of the former was more than that of the latter. In examining the influence of the type of sector on the level of accounting conservatism, dummy variables were used. The three sectors were given three numbers: the financial no. (1), the industrial (2), and the services (3). The regression of the type of sector on (BTM) ratio was assessed. From table (5) the (β_3) of the sector variable was positive. This indicates that the financial sector was more conservative than the industrial and service sectors, as this variable showed no statistical significance. This variable did not have any statistical significance at level 5% or 1%. The results based on the Book-to-Market approach were different from the results reached at in Basu 1997 model. Thus, if we want to outweigh one of the two results, we take those of Basu model because the results based on Book-to-Market approach might be less accurate for the regression model includes variables not found in the model. The result reached through using Basu 1997 model copes with the results of past studies concerned with similar things.

4. Discussion of Findings and Recommendations

The idea of this study aims at measuring the level of accounting conservatism in the financial statements issued by the companies listed on the Kuwait Stock Exchange. The study was similar to other ones conducted in Jordan, Saudi Arabia, and Bahrain. To achieve the objectives of this study, two methods were adopted in order to measure the level of accounting conservatism and the factors influencing Kuwaiti companies. The models were: Basu 1997 model and Book-to-Market Approach. The study concluded with significant results which are: We measured the level of accounting conservatism in the financial statements of all Kuwait companies through using the Basu 1997 model. It was clear from the results that the financial statements issued by those companies were conservative. To reinforce these results, we also used the Book-to-Market ratio to test the accounting conservatism in the financial reports, using the Parametric and non-parametric tests. The Parametric test assured the results reached at by Basu 1997 model which revealed that the financial statements issued by Kuwait companies were all distinguished for the reasonable level they had. Such a result did not agree with the results of past studies 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-Sahli's, 2009) study which also showed that Saudi companies never presented any accounting conservatism when preparing financial results. Many studies conducted in other environments (see Ball, Kothari, Robin, 2000; Ball, Robin, Sadka, 2008). Accounting conservatism in Kuwait Stock Exchange showed an increasing demand for: accounting information in (KSE), more powerful censorship by owners, more financial analysts, and more governmental bodies. After evaluating the level of accounting conservatism in all Kuwait companies, we investigated the influencing factors on the conservatism level. We proposed three factors: company size, debt contracts, and the type of sector to which the company belongs. We tested the influence of such factors, using Basu 1997 model and the Book-to-Market approach. The results were as follows: Regarding the influence of company size on the level of accounting conservatism, we tested this relation by using Basu 1997 model. We divided the companies into big and small according to the size of their assets. Afterwards, we assessed the Basu 1997 model in both the small and big companies. 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 not agrees with the study of Hamdan (2010) which proved the influence of the size on the level of conservatism in Jordanian companies, which showed that the large companies are more conservatism. To verify these results, we examined the regression of company size on (BTM) ratio. The results were not different from the findings arrived at by using the Basu 1997 model. The relation, in the second model, between the size and the level of accounting conservatism was positive with statistical significance. This implies that there is impact of the company size on its accounting conservatism. Such a result agrees with Al-Sahli's (2009) study which disclosed that the small size companies in Saudi financial market were more conservative. Regarding the influence of debt contracts on the level of accounting conservatism in the financial statements of the Kuwaiti company, we divided companies according to their financial leverage and evaluated the "Basu" model for the companies of high debts with those of low debts. 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. In verifying these results, it was clear that the financial leverage slop of the second model was positive with statistical significance. Such a finding implies that the size of debts (Debt contracts) influences the level of conservatism. This consolidates the findings reached at in the first model that debt contracts influence the company's accounting conservatism. This also does not reflect the pressure enforced by debtors on the company's management to be conservative in the disclosure of earnings and high level assets. This result agrees with Hamdan's (2010) study which found out that debt contracts had an effect on the level of accounting conservatism, and agree 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 companies listed on the Saudi market. Finally, in the fourth hypothesis, the economic sectors in (KSE) were put into comparison regarding the level of accounting conservatism. The financial sector was found to be more conservative than the services and industrial. This result was based on Basu 1997 model and (BTM) approach in relation to the market value. The reports issued by financial sectors were usually distinguished for accounting conservatism due to the nature of the sector that needed a high level of conservatism when disclosing earnings and assets value. Many past studies made clear that the financial sector was distinguished for having a reasonable level of conservatism more than any other sectors (Hamdan, 2010; Yaseen, 2008; Ahmed & Duellman, 2007; Lara & Osmá & Penalva, 2007; Beaver & Ryan, 2005). Our study found out that the financial reports issued by the financial sector showed accounting conservatism. But the study of Sahli (2009) found out that the financial sector in Saudi Stock Exchange did not show any distinction in its reports regarding accounting conservatism.

References

- Ahmed, A. & Duellman, S. (2007). Accounting Conservatism and Board of Directors Characteristics: An Empirical Analysis, *Journal of Accounting and Economics*, 43, PP 411-437, doi:10.1016/j.jacceco.2007.01.005, <http://dx.doi.org/10.1016/j.jacceco.2007.01.005>
- Ahmed, A., Billings, B., Morton, R., & Stanford-Harris, M. (2002). The role of accounting conservatism in mitigating bondholder-shareholder conflicts over dividend policy and in reducing debt costs, *The Accounting Review*, 11, PP 867-890
- Al-Sehli, M. (2009). Accounting Conservation in Corporate Financial Reporting in Saudi Arabia: An Empirical Study. *Arab Journal of Administrative Sciences*, 16, PP 1-22
- Awad, T. (2000). Introduction to Econometrics. Amman: Publications of Jordan University.
- Ball, R. (2001). Infrastructure requirements for an economically efficient system of public financial reporting and disclosure. Brookings-Wharton Papers on Financial Services: PP 127-182.
- Ball, R. (2001). Infrastructure Requirements for an Economically Efficient System of Public Financial Reporting and Disclosure. Brookings-Wharton Papers on Financial Services, PP 127-82.
- Ball, R., & Shivakumar, L. (2005). Earnings quality in UK private firms: Comparative loss recognition timeliness. *Journal of Accounting and Economics*, 39, PP 83-128, doi:10.1016/j.jacceco.2004.04.001, <http://dx.doi.org/10.1016/j.jacceco.2004.04.001>
- Ball, R., Kothari S., & Robin A. (2000). The Effect of International Institutional Factors on Properties of Accounting Earnings. *Journal of Accounting & Economics*, 29, PP 1-51.

- Ball, R., Robin, A., & Sadka, G. (2008). Is Financial Reporting Shaped by Equity Markets or by Debt Markets? An International Study of Timeliness and Conservatism. *Review of Accounting Studies*, 13, PP 168-205, doi:10.1007/s11142-008-9069-0, <http://dx.doi.org/10.1007/s11142-008-9069-0>
- Basu, S. (1995). Conservatism and the asymmetric timeliness of earnings. University of Rochester (Unpublished dissertation).
- Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics*, 24, PP 3–37.
- Beaver, W., & Ryan, S. (2005). Conditional and Unconditional Conservatism: Concepts and Modeling. *Review of Accounting Studies*, 10, PP 269–309, doi:10.1007/s11142-005-1532-6, <http://dx.doi.org/10.1007/s11142-005-1532-6>
- Belkaoui, A. (2005). *Accounting Theory*, 5th Edition, Thomson, USA.
- Financial Accounting Standards Board (FASB). (1980). Statement of Financial Accounting Concepts No.2 Qualitative Characteristics of Accounting Information. Stamford, CT.
- Gigler, F., Kanodia, C., & Sapra, H. (2009). Accounting Conservatism and the Efficiency of Debt Contracts. *Journal of Accounting Research*, 47, PP 767-797, doi:10.1111/j.1475-679X.2009.00336.x, <http://dx.doi.org/10.1111/j.1475-679X.2009.00336.x>
- Givoly, D., & Hayn, C. (2000). The changing time-series properties of earnings, cash flows and accruals: Has financial reporting become more conservative? *Journal of Accounting and Economics*, 29, PP 287-320
- Gujarati, D. (2003). *Basic Econometrics*, 4th Edition, the McGraw-Hill Companies, USA.
- Hamdan, A. (2010). Factors Affecting Accounting Conservatism when Preparing Corporate Financial Reports: Evidence from Jordan. *Jordan Journal of Business Administration*. Accepted Paper.
- Hamdan, A. (2011). The Impact of Accounting Conservatism on the Enhancement of the Quality of Financial Reporting: an empirical study from the Jordanian industrial corporations. *Dirasat of Administrative sciences*, 38, PP 7-45
- Hellman, N. (2008). *Accounting Conservatism under IFRS, Accounting in Europe*, 5, PP 71-100, doi:10.1080/17449480802510492, <http://dx.doi.org/10.1080/17449480802510492>
- Hendriksen, E. (1982). *Accounting Theory*. Richard D. Irwin, Inc. USA.
- Jain, P., & Rezaee, Z. (2004). The Sarbanes-Oxley Act of 2002 and Accounting Conservatism. Working Paper Series, available at: www.ssrn.com
- Krishnan, J., Visvanathan, G. (2007). Does the SOX Definition of an Accounting Expert Matter? The Association between Audit Committee Directors' Accounting Expertise and Accounting Conservatism, *Contemporary Accounting Research*, 25, PP 827-857, doi:10.1506/car.25.3.7, <http://dx.doi.org/10.1506/car.25.3.7>
- LaFond, R., & Roychowdhury, S. (2008). Managerial Ownership and Accounting Conservatism, *Journal of Accounting Research*, 46, PP 101-135, doi:10.1111/j.1475-679X.2008.00268.x, <http://dx.doi.org/10.1111/j.1475-679X.2008.00268.x>
- Lara, J., Osma, B., & Penalva, F. (2007). Board of Directors' Characteristics and Conditional Accounting Conservatism: Spanish Evidence, *European Accounting Review*, 16, PP 727-755, Doi:10.1080/09638180701706922, <http://dx.doi.org/10.1080/09638180701706922>
- Lara, J., Osma, B., & Penalva, F. (2009). Accounting conservatism and corporate governance, *Rev Account Stud*, 14, PP 161-201, doi:10.1007/s11142-007-9060-1, <http://dx.doi.org/10.1007/s11142-007-9060-1>
- Lobo, G., & Zhou, J. (2006). Did conservatism in financial reporting increase after the Sarbanes-Oxley Act? *Initial evidence, Accounting Horizons*, 20, PP 57–74.
- Paprocki, C., Stone, M. (2004). Is the Quality of Critical Accounting Policy Disclosures Lower for Companies with High Information Asymmetry. Available at: www.ssrn.com
- Penman, S., Zhang, X. (2002). Accounting Conservatism, the Quality of Earnings, and Stock Returns. *The Accounting Review*, 77, PP 1-33.
- Rao, D., & Shankaraiah, K. (2003). Stock Market Efficiency and Strategies for Developing GCC Financial Markets: A Case study of Bahrain Stock Market. Working Paper, International Conference on Financial Development in Arab Countries.
- Sifo, W., & Mashal, A. (2003). *Econometric Analysis between Theory and Practice*. Amman: Majdalawi Books.

Watts, R. (2003a): Conservatism in Accounting Part I: Explanations and Implications. *Accounting Horizons*, 17, PP 207–221.

Watts, R. (2003b). Conservatism in Accounting Part II: Evidence and Research Opportunities. *Accounting Horizons*, 17, PP 287–301.

Watts, R., & Zimmerman, J. (1983). Agency Problems, Auditing and the Theory of the Firm: Some Evidence, *Journal of Law and Economics*, Vol. XXVI, Oct.

Yaseen, M. (2008). Measure the level of Conservatism in Accounting light of Corporate Governance and its impact on the Disclosure Quality of the Financial Statements of the Jordanian Commercial Banks. Arab Academy for Banking and Financial Sciences (Unpublished dissertation).

Appendix

Table 1. Study sample-selection

Sector	Number of Companies	Sector	Number of Companies
Banks	9	Services	58
Investment	51	Food	6
Insurance	7	Non-Kuwaities	14
Real Estate	38	Parallel Market	14
Industrial	28	Total	225

Table 2. Test the validity of data for statistical analysis

Model 1					Model 2				
Panel A: Normal Distribution Test: Jarque-Bera Test									
Variable	J-B	p-value	Skewness	Kurtosis	Variable	J-B	p-value	Skewness	Kurtosis
EPS ($X_{i,t}$)	37	0.000	6	64.8	BTM _{i,t}	359	0.000	-5.9	65.2
Price ($P_{i,t-1}$)	17	0.000	5.4	46.8	Size _{i,t}	460	0.000	14.9	222.7
Net income ($R_{i,t}$)	461	0.000	14.9	222.9	Leverage _{i,t}	55	0.000	8.1	78.1
Panel B: Multicollinearity Test: Collinearity Statistics Test									
Variable	Tolerance			VIF	Variable	Tolerance			VIF
DR _{i,t}	0.916			1.092	Size _{i,t}	0.840			1.178
R _{i,t}	0.996			1.004	Leverage _{i,t}	0.945			1.058
R _{i,t} × DR _{i,t}	0.919			1.088	Sector _{i,t}	0.895			1.117
Panel C: Autocorrelation and Homoskedasticity Tests:									
Variable	D-W	F-value (White)	p-value (White)	Variable	D-W	F-value (White)	p-value (White)		
X _{i,t} /P _{i,t-1}	1.987	0.646	0.665	BTM _{i,t}	1.975	0.210	0.993		

Durbin–Watson d Statistic at $k=3$ and $n=225$ is: $d_t 1.738 - d_u 1.799$

Table 3. Testing of the first hypothesis

Panel A: Measurement of accounting conservatism using Basu model			
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} × DR _{i,t}	0.000	-3.280**	0.001
R-squared	0.247		
Panel B: Measurement of accounting conservatism using BTM			
Mean:	Book Value	Book Market	BTM Ratio
	28.429	47.898	1.284
Parametric Test: Independent Sample t-Test			
t-Statistic	p-value	Z-Statistic	p-value
-2.314**	0.048	-0.297	0.767

Significant at **1%; *5% levels. t-Critical value at df 224 and 1% level is 2.358 and at 5% is 1.658 z-Critical value 1.65

Table 4. Estimating of Basu model

Panel A: the effect of corporations size on accounting conservatism using Basu model						
Variable	Big Companies (n=58)			Small Companies (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} ×DR _{i,t}	0.000	0.258	0.797	0.000	-2.432**	0.016
Adjusted R ²	0.213			0.446		
Panel B: 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} ×DR _{i,t}	0.000	-0.285	0.776	0.000	-2.008**	0.048
Adjusted R ²	0.154			0.417		

Significant at **1%; *5% levels. t-Critical value at df 199 and 1% level is 2.358 and at 5% is 1.658

Table 5. Estimating of second model

Ordinary Least Squares			
Variable	Coefficient (β)	t-Statistic	p-value
Constant (α)	1.133	8.400**	0.000
Company size	0.000	10.045**	0.000
Financial leverage	0.008	3.595**	0.000
Sectors	-0.031	-0.537	0.592
R-squared	0.014		

Significant at **1%; *5% levels. t-Critical value at df 224 and 1% level is 2.358 and at 5% is 1.658

Table 6. Estimating of Basu model for fourth hypothesis

Variable	Financial Sector (n=77)			Services Sector (n=60)		
	Coefficient (β)	t-Statistic	p-value	Coefficient (β)	t-Statistic	p-value
DR _{i,t}	-0.371	-4.232**	0.000	-0.211	-4.959**	0.000
R _{i,t}	0.000	0.474	0.637	0.000	-3.149**	0.003
R _{i,t} ×DR _{i,t}	0.003	3.595**	0.001	0.000	-1.307	0.197
Adjusted R ²	0.532			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} ×DR _{i,t}	0.000	-1.711	0.091			
Adjusted R ²	0.425					

Significant at **1%; *5% levels. t-Critical value at df 199 and 1% level is 2.358 and at 5% is 1.658