

## Investigating the Asymmetric Recognition in the Bahrain Stock Exchange

**Allam Mohammed Hamdan**

*Department of Accounting, College of Business and Finance,  
Ahlia University, Manama, Kingdom of Bahrain*

**Mohammed Hasan Abzakh**

*Department of Accounting, College of Business and Finance, Philadelphia University, Amman, Jordan*

**Abd Almuttaleb M. A. Al-Sartawi**

*Delmon University, Kingdom of Bahrain*

**[Abstract]** In this paper, we investigate the differential speed with which good and bad news is incorporated into reported earnings. This has been characterized as an indicator of conservatism. Our analysis is based on a sample from (50) companies listed in Bahrain stock exchange (BSE) over the period of years from 2005 to 2008, using the Basu (1997) model. We have confirmed that there is a much stronger contemporaneous relationship between bad news and earnings than between good news and earnings.

**[Keywords]** asymmetric recognition; accounting conservatism; Bahrain stock exchange

### Introduction

Conservatism has important economic functions. It is widely accepted that contractual relations, litigation, regulatory incentives, and, in some jurisdictions, links between taxation and reporting influence the demand for and supply of conservative accounting behavior; 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 principle in accounting practices (Watts, 2003). The conservatism is “as capturing accountants’ tending to require a higher degree of verification for recognizing good news than bad news in financial statements” (Basu, 1997), and concludes that conservatism exists in accounting where there is more timely recognition in earnings of bad news regarding future cash flows than good news. Conservatism is reflected in the asymmetric timeliness of loss vs. profit recognition, which stems from accountants’ tendency to require a higher degree of verification for recognizing good news than bad news in financial statements: “Anticipate no profit, but anticipate all losses.”

Today, in the middle of the waves of skepticism regarding financial reports, adherence to this principle has become 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, 2010a) and conservatism, which discloses 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. 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 reducing 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 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 out that accounting conservatism helps reduce agency costs. Finally, Hamdan (2010b) 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 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 & Shivakumar, 2005; Ball, et. al., 2008). Accounting conservatism secures stricter policies for the debtors 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) saw that accounting conservatism reduces the efficiency of debt contracts because it changes the content of accounting, thus reducing the possibility of future prediction. In a 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 (2010a) and Yaseen (2008) found out that banks are the most conservative in their accounting policies. But Al-Sahli (2009) disagreed 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, (2010a) 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 was expected, Hamdan, (2010a) 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 the Saudi Stock Exchange had an effect on accounting conservatism in financial reporting and that agreed with what the study of Labo & Zhou, (2006) reached. The demands of US 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, et al. (2009), which found that corporate governance helped increase accounting conservatism. Krishnan & Visvanathan (2007) discovered that the 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). Measuring the accounting conservatism in Bahrain Stock Exchange helps in measuring the efficiency of this emerging market. Some studies indicate that 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 reports issued by the general joint-stock companies listed in Bahrain Stock Exchange? What are the factors that affect the level of this conservatism?

## Research Methodology

### *Study Model*

Methodologies used in measuring the level of conservatism in financial reporting were several. Despite the difference of the results reached 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). This study uses the Basu 1997 model of measuring accounting conservatism and the factors influencing it. 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, are 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 good ones. Thus, conservatism measurement is the difference between stock trading and earnings' indicators during the period of bad news and its relation to periods of good news (Givoly & Hayn, 2000). In line with Basu (1997), we measure conditional conservatism based on the following piecewise "reverse" earnings-on-returns regression:

$$NI_{i,t-1} = \beta_0 + \beta_1 NEG_{i,t} + \beta_2 RET_{i,t} + \beta_3 RET_{i,t} \times NEG_{i,t} + \varepsilon_{i,t}$$

Where  $NI_{i,t-1}$  is net income before extraordinary items, deflated by beginning-of-the-period market value of equity. Our return variable,  $RET_{i,t}$ , is calculated based on buy-and-hold returns for the fiscal year.  $NEG_{i,t}$  is one, if  $RET_{i,t}$  is negative and zero otherwise. Most commonly, the level of conservatism is assessed by analyzing the value of  $\beta_3$  from the prior model. If  $\beta_3$  is significantly positive, the sample under study is expected to exhibit conservatism behavior on average, as  $\beta_3$  is an indicator for the asymmetric timeliness of earnings with respect to bad vs. good news, comparing the relative levels of conservatism of two samples or of a sample with an interacted version of prior model.

### *Study Sample*

The corpus of the study comprises the (50) companies listed on the BSE, which published their financial reports between 2005–2008. The sample included all the companies of the corpus, including those delisted or closed, pending their issued financial reports during period of the study.

### *Study Hypothesis*

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

- H<sub>01</sub>: There is no acceptable level of accounting conservation in financial reports issued by the companies listed on the BSE.
- H<sub>02</sub>: There is no statistically significant impact of the company size on the level of accounting conservation in the financial report issued by the companies listed on the BSE.
- H<sub>03</sub>: There is no statistically significant impact of the debt contracts on the level of accounting conservation in the financial report issued by the companies listed on the BSE.
- H<sub>04</sub>: The economic sectors listed on the BSE are similar with regard to the level of conservatism in their financial reports.

## Conclusion

For a sample of Bahrainian firms drawn from the years 2005 to 2008, we have confirmed that there is a much stronger contemporaneous relationship between bad news and earnings than between good news and earnings. This was fully expected from theory and from prior evidence, through using the Basu 1997 model, and the results are presented in Table 1.

Table 1. *Estimating of Basu Model*

<b>Panel A: Measurement of accounting conservatism for all corporations (n=50)</b>						
Variable	Coefficient ( $\beta$ )	t-Statistic	p-value			
NEG <sub>it</sub>	1.084	1.333	0.185			
RET <sub>it</sub>	0.000	-1.755	0.082			
RET <sub>it</sub> ×NEG <sub>it</sub>	0.000	2.115	0.036			
Adjusted R <sup>2</sup>	-0.697					
<b>Panel B: The effect of corporations size on accounting conservatism</b>						
	Big Corporations (n=11)			Small Corporations (n=39)		
Variable	Coefficient ( $\beta$ )	t-Statistic	p-value	Coefficient ( $\beta$ )	t-Statistic	p-value
NEG <sub>it</sub>	0.531	27.723	0.000	1.807	1.459	0.148
RET <sub>it</sub>	0.000	0.388	0.702	0.000	-1.086	0.280
RET <sub>it</sub> ×NEG <sub>it</sub>	0.000	6.015	0.000	0.000	1.527	0.130
Adjusted R <sup>2</sup>	0.002			-0.690		
<b>Panel C: The effect of debt on accounting conservatism</b>						
	High Financial Leverage (n=24)			Low Financial Leverage (n=26)		
Variable	Coefficient ( $\beta$ )	t-Statistic	p-value	Coefficient ( $\beta$ )	t-Statistic	p-value
NEG <sub>it</sub>	-0.012	-0.370	0.713	2.184	1.518	0.134
RET <sub>it</sub>	0.000	-2.056	0.044	0.000	-1.098	0.277
RET <sub>it</sub> ×NEG <sub>it</sub>	0.000	2.626	0.011	0.000	1.957	0.055
Adjusted R <sup>2</sup>	-0.008			-0.623		
<b>Panel D: The effect of sector type on accounting conservatism</b>						
	Financial Sector (n=30)			Services Sector (n=15)		
Variable	Coefficient ( $\beta$ )	t-Statistic	p-value	Coefficient ( $\beta$ )	t-Statistic	p-value
NEG <sub>it</sub>	1.126	1.133	0.261	0.075	1.756	0.088
RET <sub>it</sub>	0.000	-1.532	0.130	0.000	-1.987	0.055
RET <sub>it</sub> ×NEG <sub>it</sub>	0.000	2.195	0.031	0.000	2.816	0.008
Adjusted R <sup>2</sup>	-0.721			0.286		

It was clear from the results that the financial reports issued by those companies were conservative. Such a result did not agree with the results of past studies conducted in similar environments, like the study of (Hamdan, 2010a), 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 on the BSE showed an increasing demand for accounting information in the BSE, more powerful censorship by owners, more financial analysts, and more governmental bodies. After evaluating the level of accounting conservatism in all Bahrain 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. The results were as follows: Regarding the influence of company size on the level of accounting conservatism, we tested this relation by using the 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 reports of the big companies were more conservative than those of the small ones. This might be referred back to the desire of big companies to shun 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 more governance over them than over the small companies. This result agrees with the study of Hamdan (2010a), which proved the influence of the size on the level of conservatism in Jordanian companies. Regarding the influence of debt contracts on the level of accounting conservatism in the financial reports of the Bahraini 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 financial reports of both the high-debt companies and the low-debt ones reflected accounting conservatism. However, companies with high debts were more conservative. This result agrees with Hamdan's (2010a) study, which found out that debt contracts had an effect on the level of accounting conservatism, but differs with it in that companies with high debts in Bahrain were more conservative, while 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 in the Saudi market.

Finally, in the fourth hypothesis, the economic sectors on the BSE were put into comparison regarding the level of accounting conservatism. The service sector was found to be more conservative than the financial one. 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, 2010a; Yaseen, 2008; Ahmed & Duellman, 2007; Lara & Osma & Penalva, 2007; Beaver & Ryan, 2005). Our study found out that the financial reports issued by the financial sector showed accounting conservatism, but at a lesser degree. 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, 411-437.
- Al-Sehli, M. (2009). Accounting conservation in corporate financial reporting in Saudi Arabia: An empirical study. *Arab Journal of Administrative Sciences*, 16(1), 1-22.
- Ball, R. (2001). Infrastructure requirements for an economically efficient system of public financial reporting and disclosure. *Brookings-Wharton Papers on Financial Services*: 127-182.
- Ball, R., & Shivakumar, L. (2005). Earnings quality in UK private firms: Comparative loss recognition timeliness. *Journal of Accounting and Economics*, 39, 83-128.
- Ball, R., Kothari S., & Robin A. (2000). The effect of international institutional factors on properties of accounting earnings. *Journal of Accounting & Economics*, 29, 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, 168-205.
- Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics*, 24, 3-37.
- Beaver, W., & Ryan, S. (2005). Conditional and unconditional conservatism: Concepts and modeling. *Review of Accounting Studies*, 10, 269-309.
- Gigler, F., Kanodia, C., & Sapa, H. (2009). Accounting conservatism and the efficiency of debt contracts. *Journal of Accounting Research*, 47(3), 767-797.
- 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, 287-320.
- Hamdan, A. (2010a). Factors affecting accounting conservatism when preparing corporate financial reports: Evidence from Jordan. *Jordan Journal of Business Administration*. Accepted Paper.
- Hamdan, A. (2010b). 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*. Accepted Paper.

- Hellman, N. (2008). Accounting conservatism under IFRS. *Accounting in Europe*, 5(2), 71-100.
- 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(3), 827-857.
- LaFond, R., & Roychowdhury, S. (2008). Managerial ownership and accounting conservatism. *Journal of Accounting Research*, 46(1), 101-135.
- Lara, J., Osmá, B., & Penalva, F. (2007). Board of directors' characteristics and conditional accounting conservatism: Spanish Evidence. *European Accounting Review*, 16(4), 727-755.
- Lara, J., Osmá, B., & Penalva, F. (2009). Accounting conservatism and corporate governance. *Rev Account Stud*, 14, 161-201.
- Lobo, G., & Zhou, J. (2006). Did conservatism in financial reporting increase after the Sarbanes-Oxley Act? Initial evidence. *Accounting Horizons*, 20, 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](http://www.ssrn.com)
- Penman, S., & Zhang, X. (2002). Accounting conservatism, the quality of earnings, and stock returns. *The Accounting Review*, 77(2), 1-33.
- Watts, R. (2003a). Conservatism in accounting part I: Explanations and implications. *Accounting Horizons*, 17, 207-221.
- Watts, R. (2003b). Conservatism in accounting part II: Evidence and research opportunities. *Accounting Horizons*, 17, 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).