



## Fair Value and Earnings Management Evidence from the Kuwaiti Market

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### Abstract

**Objectives:** The present study aims to test whether the accounting information of fair values provided by International Accounting Standard (IAS) No. 39 is used for earnings management purposes in Kuwaiti market.

**Method:** This study performs regression analysis using data related to a number of Kuwaiti firms to examine whether firms engage in gains trading related to Available-for-Sale (AFS) securities, and whether these gains trading, if any, are associated with proxies of firm's political visibility, executive compensation, and credit financing.

**Results:** The empirical results reported show evidence of gain trading practices by Kuwaiti firms, and that this gain trading is significantly related to firm size (e.g., political cost) and profitability (i.e., executive compensation), but not related to firms debt ratio.

**Conclusion:** The study is supposed to be of a value to the international accounting literature as it provides, for the first time, empirical evidence about the practice of gains trading from the Gulf Cooperation Council (GCC) region. The study's results are also expected to be of a value to regulators and policy makers for better regulatory supervision over corporate financial reporting.

**Keywords:** Fair value, Earning management, Securities, Accounting standards, Kuwait.

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## Introduction

For about two decades, fair value has been vastly adopted by almost all accounting rule-making bodies around the world (e.g., FASB & IASB) as a method for accounting for financial assets. The aim of applying fair value accounting is to increase the usefulness and representation of accounting information for market participants (Tutino & Pompili, 2018). The adoption of fair value was controversial, however. Advocates of this method argued that it enhances financial reporting transparency, and provides more relevant information than the historical cost method does (e.g. Hitz, 2007; Allen & Carletti, 2008). This has been supported by empirical findings reporting an incremental value relevance of fair value disclosure and recognition (e.g., Petroni & Wahlen, 1995; Barth et al., 1996; Nelson, 1996; Park et al., 1999). Fair value adversaries, on the other side, have criticized fair value accounting for unduly increasing the volatility of accounting numbers (ECB, 2004), and for providing firms with the ability to manipulate accounting numbers (Beatty, 1995; Ronen, 2008).

Criticism of fair value has even grown after the emergence of the 2008 financial crisis, when fair value accounting was cited as a significant reason for amplifying the crisis (Fiechter, 2011). Fair value accounting was particularly blamed for providing firms management with a significant discretion and the ability to conveniently reclassify and/or short-term sell financial assets. Under International Accounting Standard (IAS) No. 39, Financial Instruments, Recognition and Measurement, financial assets are required to be classified into one of four categories; Held For Trading (HFT), Available For Sale (AFS), Held-To-Maturity (HTM), or Loans and Receivables (LR). Depending on their classification, financial assets are then measured at (1) fair value with subsequent changes in value reported in net profit or loss, (2) fair value with subsequent changes in value reported in other comprehensive income, or (3) amortized cost using the effective interest method. IAS No. 39 also allows for the subsequent re-classification of financial assets across the different categories. Critics argue that management could abuse this significant discretion and re-classification

ability for manipulative purposes as that would allow them to expediently apply any of the three different bases of measurement that financial assets can be accounted for. The AFS category, in particular, has a peculiar accounting treatment (Barth et al., 2017). That is true since gains and losses resulting from changes in fair value are not recognized in firm's net income until the financial asset is sold. This provides management with a significant discretion as to when to report fair value gains or losses in firms financial statements. Empirical evidence reported in prior studies (e.g., Laux & Leuz, 2010) provides evidence that firms (i.e., banks) have an incentive to classify financial assets as AFS. In light of this argument, a question arises of whether this discretion has been exercised by firms to manage reported earnings. The purpose of the current study, therefore, is to empirically examine whether firms do use the discretion provided by fair value accounting to manage their reported accounting numbers.

The current study is driven mainly by the obvious shortage of research examining the impact of fair value accounting on earnings management outside the US market. In addition, and to the authors knowledge, this issue has not been examined previously in the context of a developing country's market. The present study, therefore, is expected to have a valuable contribution to the international accounting literature by exploring and providing empirical evidence for the first time about the impact of fair value accounting on earnings management from an emerging Gulf Cooperation Council (GCC) market.

The study's results reveal a significant evidence that gains trading is practiced in the Kuwaiti market, and that this gains trading is positively related to the firms size and profitability. The results, however, do not show any significant relation between gains trading and firms debt.

## **Background & Literature Review**

### **Fair Value Accounting**

IAS No. 39 establishes guidance for the recognition, and measurement of financial instruments in the financial statements. This standard requires the use of fair value in accounting for financial

assets, and the recognition of gains and losses resulting from changes in the fair value of certain assets in financial statements. Financial instruments are defined as “contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise”. (IASB, 2011, p. 350). Fair value is defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.” (IASB, 2011, p.350). Fair value can be measured by quoted market prices if available, or by reasonable models of estimation (Powers, 1995, p. 34). This statement has been in effect since the beginning of 2001. Since then, however, IAS No. 39 has witnessed several revisions and amendments due to the complexity associated with its implementation. The recent version of this standard requires financial assets to be classified into one of the following categories;

- (1) Financial Assets at Fair Value through Profit or Loss (FVPL), which includes financial assets that are acquired "principally for the purpose of generating profit from short-term fluctuations in prices" (IASB, 2011, p. 350),
- (2) Loans and receivables, that includes financial assets not quoted in active markets that have fixed and determined payments.
- (3) Held-To-Maturity (HTM), which includes debt investments that the enterprise has both the positive intent and ability to hold to maturity (IASB, 2011), and
- (4) Available-For-Sale (AFS), which includes financial assets that are not classified in any of the other categories (IASB, 2011).

While requiring all financial assets to be measured initially at their fair (market) values, their subsequent measurement depends on their category classification. Specifically, IAS No. 39 requires that unrealized holding gains and losses from changes in fair value of FVPL financial assets to be included in period’s net profit or loss, and gains or losses resulting from fair value changes in AFS financial assets to be reported in other comprehensive income (IASB, 2011).

Since the recognition of unrealized fair value holding gains (losses) of a financial asset is different for each specific category, the

classification of financial assets can have a significant impact on reported financial statement numbers in case the financial asset is sold (Fiechter, 2011). As indicated, the FVPL securities are held for short periods of time (e.g., months or days), and companies typically trade them accordingly. In addition, the HTM securities are subject to the fairly restrict "intent and ability" classification requirements.

Securities that are classified as AFS, on the other hand, provide management with a good deal of discretion, since rules governing their holding period are fairly relaxed. That is true since IAS No. 39 requires any unrealized securities gains and losses related to AFS to be included in the other comprehensive income, not the income statement. This standard, on the other hand, requires realized gains and losses on AFS to be included in the reported income. It appears, therefore, that the AFS classification provides management with the flexibility of influencing reported income by selling AFS securities and realizing gains in reported income whenever that is needed. This "flexibility" of the AFS category provides management with the ability to "maneuver" when securities market prices change unfavorably, and hence makes it the most typically used classification for investment securities (Carey, 1995; Jordan et al., 1997; Laux & Leuz, 2009). In fact, several accounting critics (e.g., Clark & Li, 1994; Powers, 1995; Ivancevich et al., 1996; Jordan et al., 1997; Barth et al., 2017) have suggested that the AFS category provides management with the opportunity for "gain trading" to smooth reported income. Income smoothing happens when investment securities with unrealized gains (losses), which are typically included only in the other comprehensive income, are sold for the purpose of increasing (decreasing) the reported income by realizing these gains (losses). This flexibility of the AFS category provides management with a "convenient" classification, particularly for the purpose of "smoothing" reported earnings.

### **Fair Value and Income Smoothing**

A stream of research in the earnings management literature has been interested in studying the practice of income smoothing by firm's management. The income-smoothing research suggests that managers

use their accounting mainly to reduce their firms' income-stream variability (Fudenberg & Tirole, 1995). Income smoothing occurs when managers "manage" reported income numbers to keep them coincide with certain "expected" earnings numbers. Gordon (1964) article is probably the first accounting paper to discuss this practice of earnings management. In this article, Gordon suggests that earnings growth and stability lead to stockholders' satisfaction and stock price increases. Gordon's suggestions were supported by recent accounting research (Michelson et al., 1995) finding that firms that smooth income numbers have significantly lower betas and higher stock market values. Other studies have also shown that income smoothing leads to enhancing potential stockholders' perceptions about the company (Dye, 1988), and reducing the perceived risk of firm's bankruptcy (Trueman & Titman, 1988). Prior research also suggests that higher earnings volatility is associated with negative firm value (e.g., Beaver et al., 1970; & Gebhardt et al., 2001)<sup>(1)</sup>. Another significant motivating factor for managers to "smooth" reported earnings is to "keep" their jobs. This is true since "good" and stable levels of earnings over time are typically associated with job security for managers, while instable earnings levels increase the possibility of dismissal (Defond & Park, 1997). This need to maintain stable earnings creates an incentive for managers to use discretion given to them by accounting standards to smooth reported earnings over time. As indicated, the flexibility associated with the AFS securities accounting offers managers with a powerful device to smooth earnings at their convenience.

The accounting research provides evidence that supports the existence of earnings smoothing behavior by managers (e.g., Moses, 1987; Chaney et al., 1998; Buckmaster, 2001). This research maintains

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(1) The negative relationship between earnings volatility and firm market value is expected to result from the idea that higher earnings volatility will be associated with higher cost of capital due to higher probability of violating debt agreements terms.

that earnings smoothing by managers is motivated by several incentives, including avoidance of political intervention (Watts & Zimmerman, 1978), maximization of executive compensation (Healy, 1985; Hothausen et al., 1995; Guidry et al., 1999), and/or avoidance of debt covenant violation (Sweeney, 1994). Ronen & Sadan (1981) indicate that managers can smooth reported income through several techniques, one of which is via classifications of accounting items. In this way, classificatory smoothing occurs when an accounting item is classified in a manner that allows managers to conveniently alter the reported net income. Interestingly, some recent accounting research (DeFond et al., 2018; Tutino & Pompili, 2018) shows that fair value accounting is opportunistically used for earnings management purposes related to compensation plans. Since accounting numbers are usually the basis for several business contracts, the increased volatility of the reported earnings resulting from the adoption of IAS 39 is expected to increase the contracting costs (e.g., costs related to debt covenants & executive compensation) of the firm.

In summary, fair value accounting provided by IAS No. 39 is anticipated to provide more relevant information about firms financial position and results of activities. At the same time, the accounting rules of IAS No. 39, especially those related to AFS, provide firms management with a substantial amount of discretion that could be exploited and hence introduces the chance of opportunistic financial reporting. We would expect managers, therefore, to make advantage of the discretion related to AFS to smooth earnings as needed. In particular, we would expect firms management to smooth earnings to reduce their political visibility, to maximize executive bonuses, and/or to avoid violation of debt covenants.

### **Previous Related Research**

The recent trend towards the adoption of fair value accounting standards provided an interesting topic for accounting researchers. Much of this line of accounting research (e.g., Barth et al., 1996;

Cornet et al., 1996; Nelson, 1996; Eccher et al., 1996; Beatty et al., 1996); Robinson & Burton, 2004), however, has been interested in examining the market reaction to the adoption-announcement of the new fair value accounting standards. Moreover, this research has been predominantly based on data related to the US market. Very few studies, however, have been conducted to examine the potential use of securities classificatory choice provided by fair value accounting for income smoothing purposes. Beatty (1995) was probably the first to examine this issue using data related to US bank holding companies. She found evidence suggesting that fair value accounting affected companies' investment portfolio management. Jordan et al. (1997) performed a similar examination using data related to a sample of US insurance companies. Their results revealed evidence of the use of fair value accounting for active gain trading purposes. Song (2008) used a sample of US banking firms and examined whether firms use the fair value option allowed in the FAS No. 159 (the US counterpart of IAS No. 39) to influence reported earnings. He found evidence that firms report greater levels of gain positions related to AFS subsequent to the adoption of the fair value option, suggesting that firms do manage earnings through this option. More recently, Barth et al., (2017) used a sample of US commercial banks to perform a similar examination and found evidence that banks did use fair value gains related to AFS assets to smooth their reported earnings.

It appears therefore, that previous related research has been solely carried out in the US, with very little research conducted in other parts of the world. The current study, therefore, aims at examining the relationship between fair value accounting and earnings management using data from the Kuwaiti emerging market.

## **Research Methodology**

### ***Data***

The study sample consists of data pertaining to 120 companies listed on Kuwait Stock Exchange (KSE) for the years 2013 to 2016. Data were obtained from information provided about Kuwaiti listed

companies provided by the KSE homepage. Data related to the study's variables were extracted from the annual reports of firms included in the sample. This sampling procedure initially yielded 480 firm-year observations. Owing to missing values, the study's final sample, however, was reduced to 360 firm-year observations.

Table 1 shows some information about the sampled companies for the years 2013-2016. As these table's shows, the study's final sample included 78 observations that were related to the year 2013, 91 observations that were related to 2014, 93 observations that were related to 2015, and 98 observations pertaining to 2016.

**Table 1**

*Number of Companies Included in the Study's Sample*

|                | 2013 | 2014 | 2015 | 2016 | Total |
|----------------|------|------|------|------|-------|
| Initial sample | 120  | 120  | 120  | 120  | 480   |
| Missing data   | (42) | (29) | (27) | (22) | (120) |
| Final sample   | 78   | 91   | 93   | 98   | 360   |

### Research Model

The current study uses a research methodology similar to that used in prior related research to examine whether gain trading has been practiced by firms. In particular, a regression model similar to that used in prior related research (e.g., Jordan et al., 1997) is used to examine the relation between gains trading and certain firm characteristics that represent a firm's need to manage its reported earnings. These variables include firm's size, firm's financial leverage, and firm's return on investment. The research model is specified as follows:

$$GAINS_{it} = \alpha_0 + \alpha_{1it}ROA + \alpha_{2it}LEVERAGE + \alpha_{3it}SIZE$$

**Where:**

The GAINS dependent variable in the model is a proxy of gains trading, and is measured as the net realized gains to the net unrealized gains. This variable provides a measure of gains that have actually affected reported earnings relative to gains that could have had an effect of earnings. ROA is the return on assets, LEVERAGE is the

total debt to total assets ratio, and SIZE is the log of the total assets. All for firm  $i$  at the end of year  $t$ .

## Results

Table 2 shows the descriptive statistics of variables included the study's sample. As shown, companies in the study's sample have a mean of total assets of KD 880,777,653, and a standard deviation of 3,081,516,901. The mean financial leverage ratio for the sample of companies is about 0.40, with a standard deviation of around .25. Table 2 also shows that the mean ROA of the sample of firms is 0.74%, while the dependent variable GAINS have a mean of -0.0866 and a standard deviation of .16472.

**Table 2**

*Descriptive Statistics*

|                   | N   | Min.    | Max.        | Mean      | St. Dev.   |
|-------------------|-----|---------|-------------|-----------|------------|
| GAINS             | 360 | -.95    | .54         | -.0866    | .16472     |
| Total Assets (KD) | 360 | 9173352 | 24204069000 | 880777653 | 3081516901 |
| LEVERAGE          | 360 | .00     | .96         | .4027     | .24776     |
| ROA               | 360 | -.60    | .28         | .0074     | .08515     |

Table 3 shows correlations among the study variables. As this table shows, correlations are generally moderate and the highest correlation equals 0.636 and is between the LEVERAGE variable and the SIZE variable.

**Table 3**

*Pearson Correlations*

|          | GAINS  | SIZE   | LEVERAGE | ROA |
|----------|--------|--------|----------|-----|
| Gains    | 1      |        |          |     |
| SIZE     | .126*  | 1      |          |     |
| LEVERAGE | 0.032  | .636** | 1        |     |
| ROA      | .256** | .118*  | -0.005   | 1   |

\*, \*\* p-value of statistical significance at the 0.10, and 0.01 levels, respectively.

Table 4 shows the results of the regression model. These results demonstrate that the research model is statistically significant with an F-statistic of 9.821 (p-value = .000), and has an R-square of .076. The results in this table show that the regression coefficient of the SIZE variable is statistically significant (p-value = .055) and has a positive sign. This provides support to the prediction of a positive relationship between gains trading and firm's size, as a proxy of its political visibility. The regression results in Panel B also show that the ROA variable is statistically significant as well (p-value = .000) and has a positive sign, suggesting that gains trading is positively related to firms' reported profitability. This result is consistent with findings of other research (DeFond et al., 2018) that fair value accounting is used to by firm's management to conveniently manage firm's earnings. The results, however, show that the regression coefficient of the LEVERAGE variable is statistically not significant (p-value = .459).

Overall, the results provide evidence that firms in the Kuwaiti market do use fair value accounting for gains trading, and that this gain trading is directly related to company's size and return on assets (ROA), but not financial leverage. The positive relation reported in the current study between gain trading and company's size is consistent with the political cost hypothesis suggested in prior research (e.g., Watts & Zimmerman, 1978). This result also adds some additional evidence about this relation to the documented findings of similar prior research (e.g., Moses, 1987; Michaelson et al., 1995). For example, Moses (1987) reports evidence suggesting that larger companies have more incentives to smooth reported earnings than smaller ones. The reported positive relation between gain trading of the company's profitability is consistent with the executive compensation hypothesis suggested in some recent related research (e.g., Bukit & Iskandar, 2009; Ghazali et al., 2015). The insignificant result reported about the relation between gain trading does not provide support to the debt-covenant hypothesis, but is consistent with the suggestion offered by Aman et al. (2006) that earnings management is not influenced by company's financial leverage.

**Table 4**  
*Regression Results*

| $GAINS_{it} = \alpha_0 + \alpha_{1it}ROA + \alpha_{2it}LEVERAGE + \alpha_{3it}SIZE$ |             |            |         |
|-------------------------------------------------------------------------------------|-------------|------------|---------|
| Variable                                                                            | Coefficient | Std. Error | p-value |
| Constant                                                                            | -.328       | .120       | .007    |
| ROA                                                                                 | .466        | .100       | .000**  |
| LEVERAGE                                                                            | -.033       | .044       | .459    |
| SIZE                                                                                | .031        | .016       | .055*   |
| <u>Regression summary</u>                                                           |             |            |         |
| statistics:                                                                         |             |            |         |
| R-square = .076                                                                     |             |            |         |
| F-Statistics = 9.821                                                                |             |            |         |
| P-value (F-Statistics) = .000                                                       |             |            |         |

\*, \*\* p-value of statistical significance at the 010, and 0.01 levels, respectively.

## Conclusion

The present study aims at exploring whether fair value accounting is associated with earnings management (i.e., gains trading) in the Kuwait market, and whether this earnings management practice is significantly influenced by firm's size, profitability, and/or leverage, as proxies for firms political visibility, executive compensation plans, and debt covenants respectively. Such investigation seems to be a worthwhile endeavor since accounting research investigating such a research topic in the Middle Eastern capital markets is almost nonexistent. Using data pertinent to a sample of Kuwaiti companies, this study explores and reports evidence of gains trading related to fair value accounting, and that this practice of gains trading is positively related to firm's size and profitability. The results, however, do not show evidence of a significant relationship between gains trading and firm's debt ratio. This result is, however, similar to that reported in prior similar research (Jordan et al., 1997).

The present study sheds some light on how firm's management in the Kuwait market could use fair value accounting for earnings

management purposes, and hence, raises some concerns about the possibility that fair value accounting could be resulting in a weakening of the reliability of accounting information. Hence, the study's results are expected to be of a value to accounting standards bodies in performing a post-adoption review of fair value accounting rules, and to local capital market's regulators in taking necessary actions to deter such opportunistic behaviors. The results reported by the present study are also expected to be useful in drawing conclusions about the still lacking theoretical background of the relationship between fair value accounting and earnings quality.

It is worth noting that the current study is subject to some limitations. First, study's sample is relatively small. That is mainly because of the small size of the Kuwaiti market where the total number of listed firms at the time of analysis was below 200. Future similar research is, therefore, needed to perform similar investigation using a larger sample size. Second, the current study uses a parsimonious research model that may have omitted some relevant independent variables. Future research should attempt to explore and uncover other possible factors that can be influential in explaining gains trading practices.

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## القيم العادلة للأدوات المالية وإدارة الأرباح: دراسة تجريبية من السوق الكويتي

أ. د. مشاري عبيد الهاجري

### ملخص

**الأهداف:** يهدف هذا البحث إلى دراسة المعلومات المحاسبية الخاصة بالقيم العادلة وفقاً لمعيار المحاسبة الدولي رقم (39)، وإذا ما كانت تستخدم لأغراض إدارة أرباح الشركات في السوق الكويتي.

**المنهج:** تستخدم هذه الدراسة. بشكل خاص - نموذج تحليل الانحدار على بيانات متعلقة بعدد من الشركات الكويتية لاختبار الشركات إذا ما كانت تقوم بالتعاملات الهادفة إلى خلق مكاسب باستخدام الأدوات المالية المصنفة كأدوات مالية متوافرة للبيع. وإذا ما كانت هذه التعاملات مرتبطة بدرجة الانكشاف السياسي للشركة، أنظمة الأجور للمديرين التنفيذيين لديها، أو التمويل الانتمائي لدى الشركات.

**النتائج:** أظهرت نتائج الدراسة دليلاً على ممارسات التعامل الهادف لإظهار المكاسب من قبل الشركات الكويتية، وأن مثل هذه التعاملات مرتبطة بشكل مؤثر بحجم الشركة (التكلفة السياسية) وربحية الشركة (نظام التعويضات للتنفيذيين)، ولكن النتائج لم تظهر أن تلك التعاملات مرتبطة بنسبة المديونية للشركات.

**الخاتمة:** يأمل الباحث أن تكون الدراسة الماثلة ذات قيمة تضاف إلى أدبيات البحث المحاسبي؛ حيث إنها تقدم للمرة الأولى - بحسب علم الباحث - نتائج تجريبية من أحد أسواق منطقة مجلس التعاون الخليجي عن ممارسة التعاملات الهادفة إلى المكاسب، كما أنه من المؤمل أن تكون نتائج هذه الدراسة ذات قيمة بالنسبة لمتخذي القرار والمشرعين في السوق الكويتي؛ للحصول على إشراف أفضل على إعداد التقارير المالية لدى الشركات.

**الكلمات المفتاحية:** القيمة العادلة، إدارة الأرباح، الأدوات المالية، المعايير المحاسبية، الكويت.

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