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Accounting reforms in the Middle East: A portfolio - returns approach

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This paper examines the value relevance of accounting information in selected Middle Eastern countries (Bahrain, Saudi Arabia and UAE) for the per-period and post-period of accounting reforms, which could describe the effect of accounting standards reform in these countries. The result obtained from portfolio approach shows accounting information is value relevant to investor in all selected stock exchanges. A comparison of the results for the periods before and after reforms shows an improvement in value relevance of accounting information after the reform in accounting standards in Bahrain and Saudi Arabia stock markets, while the results for UAE stock market shows a decline in value relevance of accounting information after the reform in accounting standards. It could be interpreted that following IFRS in UAE did not improve value relevancy of accounting information.

Key word: Value relevance, IFRS, accounting information, Bahrain, UAE, Saudi Arabia.

INTRODUCTION

Middle East countries have begun to implement economic reforms to stimulate private investment, promote economic growth and support the transition to market economy. Although, it is difficult to define the direct impact of the accounting system reform on economic transformation, as there are many other conditions that have influence on the transition process. However, with the central position of financial reporting and control in the economic system based on market economy, it is reasonable to assume that countries that are more effective in reforming the accounting system would move faster toward economic transformation (McGee, 2008). In this way, Middle East accounting bodies have experienced some major changes during the past several years. Prior to 1980, as a result of absence of accounting organizations there were no national accounting standards for countries in this region. Underdevelopment of accounting and auditing standards was one of the main problems for auditors' confirmative job and for investors in making investment decisions. For example, this was one of the main reasons for Kuwait's stock market crash in 1982 (Wagdy, 2001). Therefore, Middle East countries had to use accounting standards of other countries to start the process of making value relevant information. Development of accounting during this period was essentially a result of the influence of several economic factors: multinational enterprises moved in, international accounting firms entered, international financial institutions were licensed, expatriate accountants and foreign technology made a presence (Yapa and Wijewardena, 1995). After 1980 a number of important international forces created significant changes in the Middle East markets and accounting bodies. International economic/political interdependence, foreign direct investment and multinational corporate strategy, new technology, international financial markets, the growth of business services and activities of international regulatory organizations started to flourish. The core of these reforms was in the financial sectors, which enabled most of the Middle East countries to establish or resurrect their stock markets and

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improve the security market regulations. As a result of these steps, stock markets indicators such as market capitalization and foreign direct investment (FDI) to Middle East gradually increased. Khan (2006) indicates that criteria such as reliability, comparability and usefulness may be used to assess the quality of information for attracting FDI.

Wagdy (2001) asserts that investors' need for reliable and relevant financial information have been the key factors of accounting reform in the Middle East. These two factors protect domestic and foreign investors from any fraud or misleading financial data. However, value relevance approach measures both relevance and reliability because accounting information is reflected in the price (Barth et al., 2001).

Despite all efforts to develop financial markets, accounting and economic growth, a crucial gap in the literature still remains. To the best of our knowledge, there is no empirical research on identifying the effect of accounting standards reforms on value relevance of accounting information in this region. Consequently, this study aims to investigate the value relevance of accounting information in selected countries (Bahrain, Saudi Arabia and UAE). In particular, it measures whether the quality of accounting information in these countries has improved or whether it has not yet become relevant despite all efforts.

The remainder of this paper is organized as follows. The next section describes background and literature review. The third section discusses the methodology issues. Data and sample selection are presented in the fourth section. The fifth section sets out the findings of the research. Conclusions and suggestions for future research are discussed in the final section.

BACKGROUND AND LITERATURE REVIEW

A value relevance study is an evaluation of the relationship between accounting information and capital market values (market values). Beaver (2002) indicated that the theoretical groundwork of value relevance studies adopting a measurement approach is a combination of valuation theory plus contextual accounting and financial reporting arguments (accounting theory) that allow the researcher to predict how accounting variables and other information relating to market value will behave. Holthausen and Watts (2001) suggest that value relevance studies use two different theories of accounting and standard setting to draw inferences: (i) "direct valuetion" theory and (ii) "inputs-to equity-valuation" theory. Direct valuation theory proposes a link between accounting earnings and stock market value. In direct valuation theory, accounting earning is intended to be either measured or be combined with the equity market value changes or levels. However, Zaleha et al. (2008) point out that the conclusion usefulness paradigm proposes that accounting information is useful if utilized by users of financial statements, or significantly associated with their decision making (Riahi, 2000) even though the information might not be stated at their best current value (Scott, 2000). Within this conception, the main users are those who make decisions having an impact on firms' value, specifically decision-making by capital market participants (Beaver, 2002; Belkaoui, 2000). Studies seeking to demonstrate a link between accounting numbers and equity values were first published over 40 years ago. The first of such article was by Miller and Modigliani (1966), who used data from the electricity industry to demonstrate that capitalized earnings from assets make the largest contribution to marketplace value. Ball and Brown (1968) and Beaver (1968) are generally recognized as the fundamental studies on the information value of accounting numbers. Ball and Brown showed that the information content of the earnings figure is related to stock prices, and Beaver observed both price and volume reactions to earnings reports.

Numerous value relevance studies have been established; one stream of literature focuses on whether the value relevance of accounting information has declined/increased over time. Prior research provides conflicting views. On the one hand, several prior literatures have found that the value relevance of accounting information has declined in recent years (Core et al., 2003; Ely and Waymire, 1999; Francis and Schipper, 1999; Graham and King, 2000; Ho et al,, 2001; Lev and Zarowin, 1999; Marquardt and Wiedman., 2004; Thinggaarda and Damkierb, 2008). On the other hand, A number of studies also have been carried out in recent years that showed value relevance of accounting information has increased (Qystein and Frode, 2007; Dung, 2010; Filip, 2010).

Among the literature documented for the Middle East region, there is some empirical evidence on Tunisian stock market (Ben Naceur and Goaied, 2004), Kuwait stock market (El Shamy and Kayed, 2005), Tehran stock exchange (Pourheydari et al., 2008), Saudi Arabia stock exchange (Alsalman, 2003), Egypt stock market (Ragab and Omran, 2006) and in some selected countries in MENA (Anandarajan and Hasan, 2010). The findings of these studies showed selected accounting factors have influenced the perception of investors, even though the effect of these factors was not the same in different markets.

In all research studies done, none was on the reform of the accounting standards in this reign. For example, Saudi Arabia reviewed and developed accounting standards over 1996 and 1999 (Saudi Organization for Certified Public Accountants). Bahrain Commercial Companies Law 2001 requires all companies to prepare their financial statements in accordance with the International Financial Reporting Standards, IFRs (Marat and Shoult, 2005). Moreover, all companies listed on the Abu Dhabi Securities Markets (ADSM) are required to publish IFRS

financial statements since 2003 (Aljifri, 2008; Deloitte, 2007). And also to the best of our knowledge, there is no empirical research that uses regression-variations and the portfolio-returns approaches to test value relevance. Therefore, an evaluation of the value relevance of accounting information, especially after changes in the economic and accounting environment in recent years is an important area to research.

METHODOLOGY

In this study, the portfolio-returns approach was used to investigate and to operationalize the value relevance of accounting information. It was because they provide different perspectives on the issue of value relevance of accounting information. Portfolio-returns approach shows a portion of total returns that could be earned from financial statement information which control changes in the volatility of market returns over time.

The portfolio-returns approach defines the value relevance of accounting measures as the proportion of information in security returns captured by the accounting measures (Alford et al., 1993; Barzegari, et al., 2011; Chang, 1998; Francis and Schipper, 1999; Hung, 2001). Thinggaarda and Damkierb (2008) further defined value relevance as the difference between the return on the long position and the return on the short position; that is, the market-adjusted return that can be earned on the long position and the market-adjusted return that can be lost on the short position. This approach measures value relevance as the total return that could be earned from a portfolio based on perfect foresight of earnings. This study used two portfolios a) a portfolio selection based on sign (SIGN-ΔEARN, SIGN-ΔROE, SIGN-ΔCF) and b) a portfolio section based on sign and magnitude (ΔEARN, ΔROE and ΔCF).

Portfolio selection based on sign (SIGN-ΔEARN)

The Portfolio-Returns Approach is based on Alford et al. (1993), Francis and Schipper (1999), Hellstrom (2006) and Thinggaarda and Damkierb (2008). As an example, the following is the procedure for selecting a portfolio based on sign of changes in EARN. First, an earnings-based hedge portfolio is created. The primary Firm-specific return $(P_{it}-P_{it-1}+d)/P_{it-1}$ is calculated for all firms over a 15 month period. The market-adjusted return on security j, $R_{,t}$, is defined as the compound (with dividend) return minus the return on the value-weighted market portfolio for each year sample (The study uses all share index return). All companies in the total sample are ranked according to the change in accounting earnings. The change in accounting earnings is calculated on a yearly basis. A hedge portfolio is formed by going long in shares with positive earning changes and short in shares with the negative earning changes. The market-adjusted return is later calculated for both the long position and short position as an average of returns for all companies included in the long short positions, respectively:

$$R_L = \sum_{j=1}^{N_L} \frac{R_j}{N_L} \qquad R_S = \sum_{j=1}^{N_S} \frac{R_j}{N_S}$$

Where Rj is a market-adjusted return for an individual company and NL and NS are the number of companies in the long position and in the short position, respectively. Note that NL and NS are equal. The hedge portfolio return (value relevance) is defined as the difference between the return on the long position and the return on the short position: that is, the market-adjusted return that can be earned on the long position and the market-adjusted return that can be lost on the short position:

$$R_H = R_L - R_S$$

Second, for each accounting-based hedge portfolio and year, the market-adjusted returns on a portfolio formed on the basis of perfect foreknowledge of future stock returns are calculated. This portfolio takes long (short) positions in the stocks in each accounting-based hedge portfolio with positive (negative) 15-month market-adjusted returns. The market-adjusted return on this returns-based hedge portfolio in year t is denoted R_t^H where H is the type of accounting hedge portfolio. The accounting-based hedge portfolio returns are expressed as a percentage of R_t^H. This controls time-series differences in the variation in market-adjusted returns (Francis and Schipper, 1999), and the resulting ratio (denoted mkt%) describes the proportion of all information impounded in stock prices that is captured by accounting information in a given period (Thinggaarda and Damkierb, 2008).

Portfolio Selection based on sign and magnitude

As mentioned above, portfolio selection based on sign and magnitude applies to ΔEARN, ΔROE and ΔCF. The following is a description for calculating the value relevance of earning with this method. The method for calculating other factors with the same ROE and cash flow is similar. The primary calculations of market-adjusted returns are similar, based on the sign of accounting information. For example, for the ΔEARNjt portfolio, we take long positions in the stocks with the highest 40% of $\Delta EARN_{j,t}$ and short positions in the stocks with the lowest 40% of $\Delta EARN_{j,t}$; thereby, disregarding the middle 20%. Thus, both the sign and the strength of the change in earnings are extracted from the total available information in financial statements. The market-adjusted return is afterwards calculated for both the long position and short position as an average of returns for all companies included in the long short positions, respectively.

Data and sample selection

Selected countries (iBahrain, Saudi and UAE) qualify from many respects to be a good location for investment and doing business. In recent years, these countries have initiated reforms, especially in financial sectors, accounting and particularly in capital markets. Therefore, the study selected these countries because market participants in capital market need to know whether the value relevance of current accounting number is increasing or not.

Data for selected countries obtained from Gulfbase database, the stock exchange website of these countries and other database such as Bloomberg and DataStream. Observations were compared across data sources for data accuracy. The UAE sample is selected from Abu Dhabi stock market (ADSM) for the period 2001 through 2008; Saudi Arabia for the period 1993 through 2008; and Bahrain from the period 1996 through 2008. The number of companies selected was based on several criteria. First, since this study investigates the effects of accounting reform on value relevance of accounting information. It was necessary to have companies in existence both before and after the reform in order to examine the effect of the reform on the value relevance of accounting information. Therefore, companies that were listed just before or just after the reform were excluded. Second, for most companies in selected countries, the fiscal year ends in December. Since it was necessary to have a common period for the calculation of stock

return accumulation across all the sample companies, whose fiscal years ended at some time other than December were excluded from the sample. Third, overseas companies listed in Bahrain stock exchange were excluded due to their different accounting standards and regulatory. Fourth, banks and insurance companies in Saudi are excluded due to their different accounting standards. In pursuant of the application of these selection criteria, the final samples for UAE consisted of 119 firm-year observations (17 companies for 7 years). The final samples for Bahrain consisted of 216 firm-year observations (18 companies for 12 years). The final sample for Saudi Arabia consisted of 640 firm-year observations (40 companies for 15years).

EMPIRICAL RESULTS

Table 1 presents the results of portfolio approach based on the sign of accounting numbers. The results obtained from the preliminary analysis of the value relevance of accounting information based on sign and yearly are presented in panel A of Table 1. The empirical results reveal the investigated period; the highest relevancy of accounting number belongs to ΔROE (74%) at 2004 in UAE. Lower relevancy (lack) belongs to ΔCFP (-75.9%) at 2002 in Bahrain. The results in Panel B of the Table 1 based on the sign clearly demonstrate that fore-knowledge of information in the financial statements is relevant for investors in all selected countries. Investment strategies based on a preview of the sign of the change in ROE would earn a higher average market-adjusted return throughout the sample period in UAE (38.7%), Saudi Arabia (18%) and Bahrain (25.68%) than other accounting numbers. On the hand, investor based on a preview of the sign of the change in CFP would earn a lower average market-adjusted return throughout the sample period in selected countries. It means that investments based on accrual-based information are more profitable than cash based information.

The results in second and third column of panel B reveal that accounting information is value-relevant in both periods before and after reform in selected countries. In first period relevancy of ΔEARN information is more than others while in second period (after reform) relevancy of ΔROE information is more than others. A comparison of results shows value relevance of ΔCASH increased after reform in all selected countries, while value relevance of ΔROE and ΔEARN increased after reform but just in Saudi Arabia.

Table 2 presents results of portfolio approach based on the sign and magnitude of accounting numbers. The empirical results reveal the investigated period; the highest relevancy of accounting number belongs to ΔROE (76%) at 2005 in Bahrain. A lower relevancy (lack) belongs to ΔCFP (-49.4%) at 2007 in UAE. The results in Panel B of the Table 2 based on the sign and magnitude show that foreknowledge of information in the financial statements are relevant for investors in all selected countries. Investment strategies based on a preview of the sign of the change in ROE would earn a higher average market-adjusted return throughout the sample period in all selected countries. On the other hand, investor based on a preview of the sign of the change in CFP would earn lower average market-adjusted return throughout the sample period in selected countries. It means that investments based on accrual-based information are more profitable than cash based information. This conclusion is same as results of portfolio approach based on the sign.

The results in second and third column of panel B reveal that accounting information is value-relevant in both periods before and after reform in selected countries. In first period relevancy of ΔEARN information is more than others in Saudi Arabia and UAE while in second period (after reform) relevancy of ΔROE information is more than any other accounting number in all selected countries. A comparison of results shows value relevance of ΔCASH increased after reform in all selected countries, and value relevance of ΔROE and ΔEARN increased after reform in Saudi Arabia and UAE.

A comparison of the result based on two portfolio method shows that although the details of the results are not same, there are similar in conclusion and main results. Both of them show accounting numbers have value relevance in selected countries and reforms in accounting standards have effect on value relevancy of accounting information in these countries.

Conclusion

This paper has examined the impact of reforms in Selected Middle East countries on the value-relevance of accounting information in these countries. The value-relevance of accounting information is clearly supported by the current findings from portfolio approaches in the selected stock exchange. A comparison of the results for the periods before and after adoption, based on both regression and portfolio approaches, shows an improvement in value relevance of accounting information after the reform in accounting standards in Bahrain and Saudi Arabia stock exchanges, while the results for UAE stock market show a decline in value relevance of accounting information after the reform in accounting standards. It could be interpreted to mean that following IFRS in UAE did not improve value relevancy of accounting information. This may be due to the availability of only one year of data for model in the period before reform. This also may be because of economic conditions in country and world crisis in recent years.

Findings from this study are relevant to standard setters and regulators for future directions in developing accounting standards. The results may be helpful to investors for understanding capital markets of selected countries, and may also provide insights for accounting standard setters and regulators. Investors tend to be more tolerant of overvaluation when the economy and

Table 1. Portfolio-returns approach based on sign.

Year	Saudi Arabia						UAE						Bahrain					
	ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP	
	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%
1994	-1.4	-3.3	-2.9	-6.9	3.6	8.4												
1995	28.3	65.4	20.2	46.8	13.3	30.7												
1996	-1.2	-2.1	-6.8	-12.3	-6.4	-11.4												
1997	-2.8	-5.2	-3.1	-5.8	16.6	30.5							9.1	18.5	4.1	8.3	-12.8	-26.0
1998	-2.3	-2.6	-13.1	-14.6	15.3	17.0							16.0	43.6	14.5	39.3	-8.5	-23.0
1999	12.5	19.0	2.6	4.0	0.4	0.7							4.6	21.9	6.9	32.8	4.8	22.7
2000	19.7	32.0	19.8	32.3	23.0	37.5							12.5	25.7	11.7	24.1	-0.3	-0.6
2001	29.9	39.1	42.5	55.5	30.2	39.5							19.5	60.2	12.5	38.6	10.1	31.2
2002	1.6	3.2	8.2	15.8	23.9	46.2	19.4	58.1	15.1	45.1	-4.4	-13.3	-12.7	-25.0	-2.7	-5.2	-38.8	-75.9
2003	15.9	9.2	53.7	30.8	34.6	19.9	21.5	64.1	21.5	64.1	-7.3	-21.7	3.4	11.7	11.7	40.8	7.1	24.7
2004	64.6	57.5	36.9	32.8	-32.6	-29.0	-34.8	-22.6	114.	74.0	-11.1	-7.2	21.3	41.2	3.9	7.4	21.7	41.8
2005	30.2	27.9	10.2	9.4	-10.6	-9.8	30.5	42.4	-10.7	-14.8	-3.2	-4.5	17.3	32.4	15.3	28.7	-14.3	-26.9
2006	33.7	19.5	37.5	21.7	1.7	1.0	0.8	2.4	12.6	37.9	2.2	6.7	11.7	51.6	10.8	47.6	-3.5	-15.3
2007	-16.5	-26.8	-0.4	-0.7	-11.2	-18.2	49.4	49.2	46.5	46.3	-45.9	-45.8	-30.3	-89.5	-9.8	-28.9	-21.1	-62.4
2008	11.9	20.3	12.6	21.6	-2.3	-3.9	-3.3	-9.5	1.2	3.5	25.0	72.2	-1.6	-4.4	15.1	40.5	10.9	29.2

Year	Saudi Arabia						UAE						Bahrain					
	ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP	
	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%
T.Per	16.6	19.5	16.3	18.0	10.8	15.4	17.4	30.9	30.1	38.7	3.9	11.3	9.62	25.56	8.87	25.68	4.54	12.47
B.Re	6.8	14.1	3.8	8.5	8.2	14.5	19.4	58.1	15.1	45.1	0.0	0.0	10.6	27.40	9.30	26.11	1.20	5.68
A.Re	23.1	23.2	24.6	24.4	12.6	16.0	17.0	26.4	32.6	37.6	4.5	13.2	9.15	24.64	8.66	25.47	6.21	15.86

Panel A: Mean market-adjusted returns (MAR)on accounting hedge portfolio (%) and proportion of the total hedge portfolio MAR can be earned by the per-knowledge of accounting information(%mkt) based on Sign in selected countries. Panel B: Mean MAR on accounting hedge portfolio (%) and proportion of the total hedge portfolio MAR can be earned by the per-knowledge of accounting information based on Sign in selected countries. EARN= Earnings Per Share; ROE= Return On Equity Per Share; CFP= Cash Flow Per Share; T.per= total period; B.Re= Before Reform; A.Re= After Reform.

Table 2. Portfolio-returns approach based on sign and magnitude.

Year	Saudi Arabia						UAE						Bahrain					
	ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP	
	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%
1994	-7.0	-17.4	-7.0	-17.4	1.7	4.2												

Table 2. Contd.

1995	29.6	63.4	24.9	53.3	14.4	30.7												
1996	8.9	13.9	1.4	2.1	-5.0	-7.9												
1997	13.8	21.8	4.4	6.9	14.7	23.1							0.0	-0.1	-3.3	-6.4	-1.5	-2.9
1998	2.4	2.9	8.0	9.7	4.3	5.2							16.9	41.2	12.8	31.3	-8.5	-20.7
1999	21.0	26.6	10.6	13.4	-7.1	-9.0							-0.6	-2.7	-0.1	-0.6	-3.6	-15.7
2000	27.8	38.3	23.7	32.7	25.7	35.3							12.1	46.2	17.5	67.0	2.4	9.1
2001	48.0	50.6	45.4	47.8	36.1	38.0							25.4	68.1	16.6	44.5	12.4	33.3
2002	5.7	8.6	17.4	26.2	26.2	39.3	33.5	62.1	21.8	52.3	-2.2	-5.4	-9.9	-14.7	-16.1	-23.9	-1.4	-2.1
2003	-18.7	-7.6	54.9	22.4	-34.6	-14.1	10.9	27.7	24.7	62.9	-4.2	-10.7	4.3	12.3	8.2	23.9	5.0	14.4
2004	14.2	9.7	48.1	32.7	-14.2	-9.6	127.3	67.0	126.1	66.4	-18.4	-9.7	13.5	26.2	5.9	11.4	2.0	3.9
2005	39.3	35.7	29.0	26.3	-14.2	-12.9	19.5	22.4	31.0	35.7	11.1	12.8	10.4	32.8	24.1	76.0	-10.6	-33.2
2006	22.0	27.3	46.9	58.3	23.6	29.3	2.3	5.8	-4.6	-11.4	5.4	13.3	9.6	37.4	12.2	47.5	3.3	12.6
2007	-7.4	-9.2	-1.5	-1.9	0.2	0.3	-16.8	-15.4	8.7	7.9	-53.9	-49.4	-7.5	-18.3	-5.7	-13.8	-16.5	-40.4
2008	9.4	11.7	11.5	14.4	1.0	1.2	-5.3	-12.6	14.4	34.0	25.6	60.7	2.2	6.7	12.0	36.3	6.3	19.0

Year	Saudi Arabia						UAE						Bahrain					
	ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP		ΔEARN		ΔROE		ΔCFP	
	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%	%	mkt%
T.Per	16.1	20.7	25.5	23.1	9.8	13.8	27.6	30.7	31.9	35.9	3.9	11.4	7.86	22.57	9.12	28.16	2.61	7.69
B.Re	12.6	21.4	8.2	14.2	5.8	10.5	33.5	62.1	18.4	44.2	0.3	0.9	7.23	21.84	7.58	24.58	0.59	2.26
A.Re	18.5	20.2	37.1	29	12.5	15.9	26.7	20.5	34.1	34.5	4.5	13.2	8.18	22.94	9.89	29.94	3.62	10.41

Panel A: Mean market-adjusted returns (MAR)on accounting hedge portfolio (%) and proportion of the total hedge portfolio MAR can be earned by the per-knowledge of accounting information(%mkt) based on Sign and magnitude for selected countries. Panel B: Mean MAR on accounting hedge portfolio (%) and proportion of the total hedge portfolio MAR can be earned by the per-knowledge of accounting information (%mkt) based on Sign and magnitude for selected countries. EARN= Earnings Per Share; ROE= Return On Equity Per Share; CFP= Cash Flow Per Share; T.per= total period; B.Re= Before Reform; A.Re= After Reform.

financial markets are doing well, and less accepting during bear market and economic slowdowns (Al-Hogail, 2004). Future research might consider the relationship between this measure and other macroeconomic measures, such as overall growth in the economy or total market performance, which might influence investors' behavior.

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