International Journal of Economics, Commerce and Management
United Kingdom Vol. III, Issue 3, March 2015
http://ijecm.co.uk/ ISSN 2348 0386

AN APPRAISAL OF ACCOUNTING METHODS ADOPTED BY COMPANIES IN KINGDOM OF SAUDI ARABIA

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Abstract

The present study appraises the Accounting Methods adopted by companies operating in the Kingdom of Saudi Arabia. Besides, the study examines factors responsible for the selection of Accounting Method in the Kingdom using 24 years data on six companies listed in the Stock Exchange (Tadawul) from 2010 to 2013. Data were extracted from the companies' annual reports. Statistical Tools applied were Correlation and Regression Analysis. Income strategy as dependent variable and Size of the firms, Leverage ratios, Labour Force Intensity, Internal Financing as independent variables are used. The results show that significant factors responsible for the determination of Accounting Methods are leverage ratio and labour force intensity. It has been found that companies in Saudi Arabia follow more income increasing accounting policies. Moreover, the results show that these companies rely more on equity than debt and a significant amount of profit is distributed as dividends.

Keywords: Accounting methods, Income strategy, Leverage ratios, Financing, Appraisal

INTRODUCTION

The purpose of this study is to investigate the factors that affect the selection of accounting policies by managers of the companies operating in the Kingdom of Saudi Arabia. It has been observed that there are more reasons to suggest that more research is required in this field as most of the studies pertaining to this area belong to the developed nations. It is obvious that the findings of the developed nations may not be relevant to the Kingdom reason being the economic and political environment is different. This study is an attempt to examine what motivates managers to choose one accounting method over another in a Gulf Country – The Kingdom of Saudi Arabia.

The Kingdom of Saudi Arabia is located in the south western part of the continent of Asia; it occupies four-fifths of the Arabian Peninsula. It is bordered by the Red Sea from the west, the Arab Gulf, United Arab Emirates, and Qatar from the east, Kuwait, Iraq, and Jordan from the north, and by Yemen and the Sultanate of Oman from the south.

Currently the Saudi Arabian Monetary Authority (SAMA, which is the Saudi Arabian Central Bank) requires banks and insurance companies in Saudi Arabia report under IFRSs. SOCPA standards apply to all other companies, listed and unlisted. Saudi Organisation for Certified Public Accountants (SOCPA) is a professional organisation established under Royal Decree No. M12 in 1991. It operates under the supervision of the Ministry of Commerce in order to promote the accounting and auditing profession and all matters that might lead to the development of the profession and upgrading its status. A thirteen members Board manages SOCPA affairs, and practices the powers required for realizing its objectives which include review, development, and approval of accounting and auditing standards. SOCPA has approved an IFRS convergence plan by which listed entities other than banks and insurance companies would be required to report under SOCPA standards that will be IFRSs with some modifications. IFRSs as issued by the IASB would be modified in three possible ways: 1- Adding more disclosure requirements. 2- Removing optional treatments. 3- Amending the requirements that contradict Shariah or local law, taking in consideration level of technical and professional preparedness in the Kingdom.

The IFRS transition plan is part of a project called 'SOCPA Project for Transition to International Accounting & Auditing Standards'. The SOCPA started the project in 2012 and expects to complete it around 2017. SOCPA's stated goal for the project is to make a transition towards IFRSs after assuring their suitability to the Saudi environment through SOCPA's independent Standard-setting process. In this is situation of mixed and incompatible regulations, managers use their discretion in deciding which accounting standards to apply in the preparation of financial statements, without violation the regulations. The objective of the present study is to appraise the factors that influence managers' decisions in adoption of accounting policies.

Watts and Zimmerman (1986) assumes that the market is efficient enough that the market participants will see through observable smoothing devices such as accounting policy choice. Holthausen (1990) points out three overlapping perspectives on accounting choice: opportunistic behaviour, efficient contracting and information perspectives. Firms tend to choose accounting methods to smooth income. (Beattie et al. 1994) In order to smooth their income, managers often choose accounting methods to expand or contract income to fulfil their own interest. Tawfik (2006) investigated the variables affecting both single policy and portfolio strategies accounting choices in Saudi Arabia. Rahman and Scapens (1998) found evidence that MNCs did not consistently use income reducing policies in Bangladesh.

Research Hypotheses

1.1 Company size is significantly related to the adoption of accounting methods that shows a decrease in reported income.

1.2 The companies' leverage ratio is significantly and positively related to the application of accounting methods by managers and this accelerates the reporting of income.

1.3 Labour force intensity is significantly associated with the accounting methods that accelerate the reporting of income.

1.4 The proportion of retained earnings to net assets is significantly and negatively associated with the selection of accounting methods that increase reported income.

RESEARCH METHODOLOGY

Study & Data Collection

The research is based on secondary data. The data have been taken from annual reports of the 6 companies of the kingdom listed on the stock exchange (Tadawul). (See Appendix 1 for the list of companies). The data collected belong to a four year period from 2010 to 2013, which resulted in 24 firm years. Where information was not available in annual reports, data were obtained from the websites of the companies, stock exchange, SOCPA and SAMA.

Income Strategy Measurement

Accounting policies that are disclosed in the companies' annual reports are taken for the study. The accounting policies have been categories into two: as income increasing and income decreasing policies. These policies have been extracted from the notes to the financial statement contained in annual reports of the companies. We identified 10 relevant items that can affect income.

Table 1: Selected Accounting Items that affect Income

Items	***Increase in Income***	***Decrease in Income***
Depreciation	Accelerated	Straight Line
Employee Benefit	Expensed	Liability (to be paid in future)
Freehold Land & Building	Revaluation	Cost
Goodwill	Revaluation	Cost
Intangible Assets (Software)	Fair Value	Cost
Inventory	Weighted Average Cost	FIFO
Investment Property	Revaluation	Cost
Leasing	Sum of the Digits Method	Actuarial Method
Marketable Securities	Fair Value	Cost
Property, Plant & Equipment	Revaluation	Cost

We define income strategy as a portfolio of accounting policies which may increase or decrease reporting income (Missonier, 2004; Inoue and Thomas, 1996; Zmijewski and Hagerman, 1981). The income strategy as a variable is the ratio of the number of income increasing accounting policies divided by the total number of accounting policies used by a company (i.e. sum of income increasing and Income decreasing policies). In measuring the income strategy we assume that the effects on income of all 10 accounting policies are equal (Table 1).

We apply the following Ordinary Least Square (OLS) regression model, which is based on our hypotheses development.

Income Strategy = $\alpha_0 + \alpha_1$ Size $+\alpha_2$Leverage $+\alpha_3$Labour Force Intensity $+\alpha_4$Internal Financing $+\varepsilon$

Income Strategy = % of the accounting policy selection that increase the income (number of accounting policies accelerating income divided by total number of accounting policies)

Company Size = Company size measured as the Amount of Total Assets Collected at the end of financial year from the Annual Reports of the companies

Leverage = Leverage Ratio measured as total long term debt scaled with total book value of equity, collected at the end of financial year from the annual reports.

Labour Force Intensity = Labour Force Intensity, measure as the total labour charges scaled by the total annual turnover of the company.

Internal Financing = Internal Financing, calculated as the percentage of appropriated retained earnings scaled by the net assets.

ANALYSIS & FINDINGS

Descriptive Statistics

Table 2 depicts a summary of the descriptive statistics of the dependent variable (Income strategy) and Independent Variables (Company Size, Leverage Ratio, Labour Force Intensity, Internal Financing).

Table 2: Descriptive Statistics

Variables	Mean	Median	S.D.	Min.	Max.
Income Strategy	0.610	0.500	0.483	0.330	0.800
Company Size	630.895	296.510	933.755	12.570	2906.900
Leverage Ratio	0.402	0.480	0.278	0.019	1.008
Labour Force Intensity	0.642	0.693	0.470	0.434	0.928
Internal Financing	0.259	0.291	0.185	0.141	0.610

Table 2 shows that the mean income strategy is 61 per cent. Consequently it can be said that the companies in Saudi Arabia follow more income increasing accounting policies that of income decreasing. The mean leverage ratio of 0.402 illustrates that the amount of Debt is less than half of the amount of equity, meaning that the companies rely more on equity than debt for the procurement of their finance. The mean internal financing is 25.9 per cent of the total net assets, which supports that a significant amount of profit is distributed as dividends.

Correlation Matrix

We have used the Pearson's Correlation matrix to determine the correlation between dependent variable (Income Strategy) and Independent Variables as well as among the independents variables.

Table 3: Correlation Matrix

Variables	Income	Size	Leverage	Labour Force Intensity	Internal Financing
Income	1.000				
Size	(-)0.061	1.000			
Leverage	(-)0.568***	(-) 0.374	1.000		
Labour Force Intensity	0.712***	0.213	(-) 0.602***	1.000	
Internal Financing	(-) 0.835***	0.091	0.080	(-) 0.504**	1.000

****, **, * Significant at 1%, 5% and 10% respectively.*

There is the highest correlation between dependent variable (Income Strategy) and independent variable (Internal Financing) i.e. (-) 0.835. Labour Force Intensity (i.e. 0.712) is positively and highly correlated with the Income strategy of the companies in Saudi Arabia (Table 3).

Multiple Regression Analysis

Table 4: Multiple Regression Results

Variables	Coefficient	S.E.	Beta	t-statistics
Size	0.622	0.235	-0	0.260
Leverage	0.877	0.037	-0.407	2.92**
Labour Force Intensity	-0.133	0.165	1.065	(-)4.309***
Internal Financing	1.072	0.129	-1.715	6.44***

****, **, * Significant at 1%, 5% and 10% respectively.*

It has been found that the company size is not significantly related to the selection of accounting methods, therefore the first hypothesis is rejected. However the relationship is positive, which means that larger companies are more likely to adopt income increasing accounting policies. It has been observed that the leverage is significantly and positively related to the choice of accounting policies, hence the second hypothesis is accepted. Labour Force Intensity is found to be negatively correlated to income strategy, which suggests that labour intensive companies choose income decreasing accounting policies in order to discourage demand for increase in wages. The findings is consistent with the third hypothesis as a result. It has also been found that there is a significant positive relationship between Internal Financing and Income Strategy, therefore the fourth hypothesis is not supported (Table 4).

CONCLUSION AND FUTURE DIRECTION

This study is an attempt to examine the factors responsible for the choice of the accounting methods in Gulf Countries in general and in the Kingdom of Saudi Arabia in particular. There may be differences among the behaviour of the managers of developed nations and developing ones due to differences in their economic, social and political scenario. Moreover the findings of the research should be interpreted keeping in view the sample size of the study. A sample size of 24 firms years is too small to provide a conclusive evidence in the context of Gulf Countries. It is therefore, suggested to have more research in other Gulf Countries like UAE, Bahrain, Qatar, Kuwait and that too with a large number of companies listed on their stock exchange.

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APPENDIX 1

List of Selected Companies Listed on Saudi Stock Exchange (Tadawul)

No.	*Names of the Companies*	*Acronym*
1.	Saudi Basic Industries Corporation	SABIC
2.	Arabian Cement Company	ARCCO
3.	Jarir Marketing Company	JARIR
4.	Saudi Electricity Company	SECO
5.	Almarai Company	ALMARAI
6.	Saudi Telecom	STC