



Value relevance of earnings, book value and dividends in an emerging capital market: Kuwait evidence

Osama M. Al-Hares ^{a,*}, Naser M. AbuGhazaleh ^{a,1}, Ayman E. Haddad ^{b,2}

^a College of Business Administration, Gulf University for Science and Technology (GUST), P.O. Box 7207, Hawally 32093, Kuwait

^b College of Business and Economics, American University of Kuwait (AUK), P.O. Box 3323, Safat 13034, Kuwait

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ABSTRACT

This study examines the value relevance of book value, earnings and dividends for a sample of all non-financial firms listed on the Kuwait Stock Exchange (KSE) over the period 2003–2009. After controlling for the impact of the global financial crisis, empirical results provide evidence on the value relevance of book value and earnings in the KSE. The results indicate that dividends are not a value-relevant in the presence of earnings in the valuation model. However, when dividends are used as a substitute for earnings they become value-relevant. The explanatory power of the model including both book value and earnings is almost indistinguishable from that of book value and dividends. Furthermore, splitting earnings into dividends declared (or paid) and earnings retained results in each of the two variables becoming value-relevant. The average dividend pay-out ratio tends to increase over time, indicating that dividend policies do matter in the KSE and that dividends in Kuwait are used to boost investors' confidence and support share price, noticeably during the global financial crisis period.

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1. Introduction

Financial statements are considered the most important source of information for stakeholders. Investors use financial statements to evaluate the share price of a firm by using valuation models. The general purpose of valuation models is to assess the impact of accounting information on stock prices. The ability of accounting data to summarize information affecting equity value is usually measured by the explanatory power of regression analysis as measured by R^2 . Valuation models with higher R^2 s indicate the ability of accounting

* Corresponding author. Tel.: +965 2530 7408.

E-mail addresses: Alhares.O@gust.edu.kw (O.M. Al-Hares), AbuGhazaleh.N@gust.edu.kw (N.M. AbuGhazaleh), ahaddad@auk.edu.kw (A.E. Haddad).

¹ Tel.: +965 2530 7431.

² Tel.: +965 2224 8399.

data to explain the variations in stock prices. The value relevance of accounting information using cross-sectional valuation models has a substantial history in accounting and other literatures.

Market-based accounting research (MBAR) often chooses between price models and return models. In price models, stock prices are regressed against earnings per share, whereas in return models, returns are regressed on scaled earnings variables (Kothari & Zimmerman, 1995). Prior value-relevance research is primarily based on the price model suggested by Ohlson (1995) and its subsequent refinements (e.g., Feltham & Ohlson, 1995).

This study assesses the value relevance of accounting information in explaining the variation in stock prices for firms listed on the KSE as an example of an emerging Gulf cooperation council (GCC) market. Using a sample of 667 firm-year observations, the study employs Ohlson's (1995) valuation equation to investigate the value-relevance of earnings, book value and dividends in Kuwait.

After controlling for the impact of the global financial crisis, empirical results provide evidence on the value relevance of book value and earnings of Kuwaiti listed firms. Dividends are found to be insignificant in the presence of earnings in the valuation model. However, when dividends are substituted for earnings, the estimated coefficient of dividends becomes positive and significant. The explanatory power of the model including both book value and earnings is almost indistinguishable from that including book value and dividends. Furthermore, splitting earnings into dividends declared (or paid) and earnings retained results in each of the two variables becoming value-relevant. Results from estimating the annual cross-sections provide evidence consistent with prior research that the value relevance of accounting information (measured by R^2 values) in Kuwait has declined over time (e.g., Balachandran & Mohanram, 2011; Core, Guay, & Buskirk, 2003; Donto, Radhakrishnan, & Ronen, 2004; Elliott & Jacobsen, 1991; Entwistle & Phillips, 2003; Francis & Schipper, 1999; Lev & Zarowin, 1999; Ramesh & Thiagarajan, 1995). The results also indicate that the average dividend pay-out ratio tends to increase over the study period, indicating that dividend policies do matter in Kuwait and that dividends are used to boost investors' confidence and support share prices, noticeably during the global financial crisis period. Furthermore, the value relevance of accounting information is not driven by industry effects in the KSE. However, the information content of accounting information is significantly higher for large Kuwaiti firms compared to their small firm counterparts.

This study contributes to the existing literature via examining the value relevance of accounting information and particularly dividends for firms listed on the KSE as an example of an emerging GCC market. Prior studies provide evidence on the value relevance of book value and earnings for Kuwaiti listed firms (e.g., Alfaraih & Alanezi, 2011; ElShamy & Al-Qenae, 2005), whereas the role of dividends in determining stock prices remains an empirical issue. In addition to examining the value relevance of earnings and book values, this study is the first to examine the value relevance of dividends utilizing Kuwaiti data. Furthermore, Al-Deehani and Al-Loughani (2004), in a research survey, indicate that managers in Kuwait are mainly motivated to pay dividends by two sets of value relevant motives. These are the "cliente-effect set" and the "signaling set". They argue that dividend policies affect share value and are not determined residually, as suggested by Miller and Modigliani (1961). The findings of this study provide further empirical evidence on the value relevance of dividends and earnings for firms listed on the KSE.

KSE was established in 1977. It was, however, reorganized in August 1983 as an independent financial institution managed by the Exchange Committee and the executive administration. KSE is one of the first and largest stock exchanges in the Middle East. Listed companies on the KSE are divided into seven sectors; banking, insurance, investment, real estate, industry, services and food. In September 2000, the Foreign Investment Law was issued by the Government to allow foreigners for the first time to invest in the KSE. The total market capitalization of the KSE increased consistently from US\$ 59.5 billion in 2003 to US\$ 122.3 billion in mid-2009, placing it as the second largest GCC stock market after Saudi Arabia.

International Financial Reporting Standards (IFRS) are mandatory in Kuwait and the government controls the accounting and auditing professions. Hence, it can be argued that countries applying IFRS may allow varying degrees of deviation from clean surplus relationship than that observed by prior studies applying the US or other local Generally Accepted Accounting Principles (GAAPs). Therefore, it is possible that the information content of accounting information in Kuwait may vary.

Moreover, equity ownership in Kuwait is often concentrated among small groups of major shareholders: the government and its agencies, dominant families, and institutional investors. These groups may influence

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