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ASSETS EVALUATION METHODS DIFFERENTIATION AND PROFITABILITY IN KUWAIT ISLAMIC BANKS

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ABSTRACT

This study aims to evaluate the impact of adopting whether fair value model or cost model on the profitability of the Islamic banks' sector in Kuwait. The quantitative approach is used to construct the adopted methodology. The population of the study is the Islamic banks that are listed in the Kuwait security market. The sample of this study composites 6 Islamic banks operating in Kuwait. The data source of this study was retrieved from the audited annual report listed in the Kuwait security market. The data used is over the period 2014 and 2020. The finding of this study revealed a significant relationship between both models on the Islamic banks' sector profitability. Also, no significant difference is found in profitability among the natural Islamic banks that follow either the fair value model or the cost model. It recommends this study to the Islamic banks to report their investment at fair value, agreeing with IAS40.

1. Introduction

The key considerations regarding the fair value that the bank sector should have in mind when this is the criterion of valuation of a financial instrument based on IAS 40 are the following: The fair value is the price that would be obtained for selling an asset or the payment for transferring a liability in an orderly transaction between market participants at the measurement date; therefore, overvalued or underestimated valuations are excluded due to agreements or particular circumstances, such as liquidation of the entity, sale and subsequent lease of the asset, special financing concessions, among others. The fair value must reflect current market prices and rates (Araya & Miras, 2015), liquidity conditions and market depth, credit risk, and other relevant variables (Goh, Li, Ng, & Yong, 2015).

The estimated fair value is for a given date, and since market conditions may vary over time, which value may be inappropriate for another date. The fair value is the amount at which interested parties would negotiate, duly informed and in conditions of mutual independence. In that context, interested and duly informed means that both the seller and the buyer are informed about the nature and characteristics of the asset, its status, the market and other conditions. On the other hand, mutual independence refers to the fact that the buyer and seller do not have a particular or unique relationship, which may mean that the price of the transaction is not representative of an operation carried out under market conditions (Yao, Percy, & Hu, 2015).

2. Islamic Banks in Kuwait

The Islamic banking system is the most developed in Kuwait, with a growth rate of 23.2% between 2002 and 2008 compared to 14.3% for the traditional banking system. While the total assets of Islamic banks amounted to 29% of the total banking assets in Kuwait, this percentage places Kuwait in the third position among the Arab Gulf countries, after Saudi Arabia and Bahrain. While the rate of acquisition of conventional banks decreased to 60%, recording a 17.4% growth rate with a total profit of 428 million KD.

In light of the growing growth of Islamic banks in Kuwait, traditional banks face years of intense competition, and their increasing market share has been affected. Regarding the losses of their clients or depositors, these banks are aware of these developments and have taken steps. One of the most prominent of these steps is that many traditional banks started providing Islamic services and products. It launched several funds compatible with Islamic Sharia to seize part of the growing market. Many traditional banks have expanded outside Kuwait by opening new branches abroad or making acquisitions to exit the local market, which has become narrow for these banks in light of the high intensity of competition in it and the lack of opportunities. The consolidation between traditional banks has been presented for many years as one

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of the solutions that enable these firms to face the risks of competition. With Islamic banks, except that all consolidation attempts and the absence of a real desire among the major owners of these banks always stand in the way of any merger attempt.The Islamic banking industry in Kuwait faces many challenges as follows:

This requires the preparation of staff familiar with the legal and banking aspects to work to ensure compliance with the legal controls of banking. Research conducted in this field has confirmed results related to the lack of planning for human resources in Islamic banks and the non-description of jobs and tasks for workers in Islamic banks (Mohammed Abdulellah Yousuf Saeed, Bekhet, & Dhar, 2017); (Mohd Abdulellah Yousuf Saeed, Bekhet, & Sciences, 2018). To describe the interactions between diverse investors, most researchers compared the various investors' models and applied them to markets (Silassie, Dahalan, & Muhammad, 2021). Therefore, the lack of a straightforward method for selecting and testing workers according to specific criteria focuses on the need to prepare and develop workers in the short, medium and long terms. The challenge facing Islamic banks is their need for mechanisms that can reconcile their mission in development and land reconstruction, which requires savings in long-term projects with high risks and the desire of depositors to liquidate deposits with less risk quickly. To overcome this problem, Islamic banks should devise long-term, easy-to-liquid investment tools such as securities and investment funds. They must also develop mechanisms to pump and absorb liquidity, such as Islamic financial markets.

3. Literature Review

According to Quagli and Avallone (2010), by the mid-40s, the SEC had already finished with revaluations in listed companies. According to (Georgiou & Jack, 2011), "it seemed that the SEC agreed with the revaluations from a theoretical point of view but with the validity of the valuation methods used. It is notorious that support for historical cost at the time was conceived as an attempt to curb fraud and misinterpretation, essentially an ethical approach. On the other hand, the interaction between the SEC, the AIA (currently AICPA) and the AAA created the American accounting standardization in the early 1930s.

According to Liang and Riedl (2013), the change in trend is primarily explained by the change in the post of chief accounting officer of the SEC in 1972. Andrew Barr, who had been working for the SEC since the 1930s, is relieved by John C. Burton, a professor at Columbia University. The latter had studied accounting at Haverford College with Philip W. Bell. Precisely Bell (together with Edgar O. Edwards) published a book in 1961 entitled The Theory and the Measurement of Business Income. The authors defend the use of "current value" in accounting. In the 1970s, and in a context in which inflation rates increased dramatically, the FASB (which had happened to the APB in July 1973) issued a draft in 1974 entitled Financial Reporting in Units of General Purchasing Power. This draft recommended that companies' financial statements include a recalculation of the values of assets and liabilities considering changes in the general price level. The chief accounting officer of the SEC stressed that revalued balance sheets considering inflation would not give investors better information than conventional balance sheets.

However, he added what, for Poon (2004) was a revolutionary statement: "it is essential that a rapid movement be carried out to replace cost accounting so that investors can perceive the effects of inflation on the activities of the companies. In August 1975, the SEC announced a proposal to revise the S-X Regulation to require several large companies to provide breakdowns concerning replacement costs. The proposal (which affected some 1,000 non-financial companies) was specified in SEC document ASR (Accounting Series Release) 190. For Poon (2004) "although the requirement regarding replacement cost information does not it was reflected in the 'body' of the financial statements and was not subject to audit. This was nevertheless a historical change about the SEC's defense of the acquisition cost". On the other hand, and in relation to the accounting of quoted shares, fair value in the US in the 1970s began to be extended thanks to specific accounting literature, which promoted its use in some circumstances. It should be noted that, at this time, there were still several accounting practices applicable to listed instruments: cost, fair value, the combination of both for different asset classes, etc.

Although there is numerous scientific literatures dedicated to the different aspects of the application of fair value, there are very few studies specifically dedicated to the investigation of fair value from a historical perspective (Georgiou and Jack, 2011). A first notable study is that of (Camfferman & Zeff, 2007). The author tries to demonstrate how the SEC had a decisive influence on adopting the accounting model based on the historical cost from 1934 (the birth of the SEC) until the 70s. The author uses quotes from the various SEC offices, uses studies issued by that institution, analyzes the different institutional relationships, etc. The conclusion reached is that the SEC's position favouring the Cost Model explains the deep adherence to accounting at a historical cost associated with accounting in the US during much of the twentieth century (Zeff, 2007). Zeff (2007) points out that from 1972 there was a change in the position of head of accounting of the SEC that led to a notable difference, which began to manifest itself in the permitted breakdowns about the "replacement cost" in the period of high inflation of the 70s and recognition of "current values" in the oil and gas companies. Ultimately, Zeff questions that the establishment of accounting principles generally accepted in the US is a process exclusively from the private sector given the great influence of the SEC.

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Also worth mentioning is the study (published in the same year) by Belze, Larmande, and Schneider (2016), in which they describe the evolution of the use of fair value in the accounting of financial instruments, focusing on the origins of the current Mixed Model, which, For the authors, it has been developed based on four decisions that the FASB made in 1996: derivatives are assets and liabilities, and as such must be recognized in the balance sheet, fair value is the most appropriate valuation method for financial instruments, only items that are assets or liabilities should be identified on the balance sheet, special accounting treatment should be allowed for hedges that meet specific requirements.

The authors analyze the Mixed Model and the FFV Model and conclude that applying the second would reduce the current complexity and discretion in using accounting standards. Emerson, Karim, and Rutledge (2010) demonstrate, through a historical analysis, how, from the moment in which after the crisis of 1929, the accounting regulation began in the US (and the different accounting-related agencies appeared), the fair value and the relevance of financial information have always been basic principles or objectives set by regulators. The authors highlight various scientific studies issued, starting in the 60s, by multiple institutions and authors. The relevance of financial information is gaining the importance of the principle of "verifiability."

4. Methodology

This study relies on the quantitative approach, which focuses on analyzing numerical data type; for this study, the data type is secondary data retrieved from the study sample's annual reports. To support the discussion of the findings, the historical analysis has been based on: 1. the review of recent scientific studies regarding the evolution of financial instrument accounting and fair value, 2. The review of historical scientific or academic studies on the accounting of financial instruments, focusing primarily on those in which aspects related to the application of fair value are analyzed. These studies will allow us to know each temporal context's academic advances and opinions.

The study population is the Islamic banks listed in the Kuwait security market. The data source of this study was retrieved from the audited annual report listed in the Kuwait security market; the data used is over the period 2014 – 2020. Access to this source is open and reachable to researchers and professional practitioners. Selecting this period is due to the slowdown of the economy domestically and globally, which affect the market value of the investment properties (Razali & Sing, 2018). Measures of variables as for independent variables = the probability a company chooses the cost model. If the company chooses the cost model, value = 1. Conversely, if the company chooses the fair value model, value = 0, while for dependent variable = net income / total assets. The obtained data from the annual reports of the sample are illustrated in tables that describe the minimum, maximum, mean, and standard deviation, besides testing the relationship between evaluation assets and liabilities to the firm's profitability. To test this study hypothesis, the independent sample T-test will test if there is a significant difference in profitability between bank companies that adopt the cost model and fair value model.

5. Findings

The obtained raw data from the sample of this study is divided into two groups, the first group for the companies that follow the fair value model. In contrast, the second group represents companies that follow the cost model. Table 1 clarifies that companies that follow the appropriate value model have a mean score of 0.039 for return on assets and 0.067 for return on equity compares to 0.025 and 0.044 for companies that follow the cost model, respectively. This confirms that companies that operate in the bank in Kuwait and use the fair value model have higher profitability ratios compared to companies that follow the cost model.

Table: 1 Descriptive Statistics- Fair value

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	9	.01	.06	.0393	.01933
ROE	9	.03	.14	.0669	.03508

Table: 2 Descriptive Statistics – Cost model

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	6	.01	.04	.0248	.01069
ROE	6	.01	.07	.0444	.01928

The correlation test is used to test the relationship between adopting the evaluation model by the firm and its profitability. Table 3 shows the result of the correlation test between evaluation and two indicators of a firm's profitability, return on assets and return on equity; the result revealed a significant relationship between evaluation and return on assets at (r=0.418, p=0.000), besides a significant positive relationship between evaluation and return on equity at (r=0.367, p=0.000). This result revealed that evaluation of the firm's assets and liabilities is linked to the outcome of the firm; furthermore, the firm's profitability varies based on the types of evaluation used by the firm.

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Table: 3 Correlation's test

		Evaluation	ROA	ROE
Evaluation	Pearson Correlation	1		
	Sig. (2-tailed)			
ROA	Pearson Correlation	.418**	1	
	Sig. (2-tailed)	.000		
ROE	Pearson Correlation	.367**	.816**	1
	Sig. (2-tailed)	.000	.000	
**. Correlation is significant at the 0.01 level (2-tailed).				

For the purpose of examining the hypothesis of this study that supposes a significant difference in profitability between bank companies that adopt the cost model and fair value model, the independent sample t-test is used. This test is designed to test whether there is a significant difference or not between two groups of data; for this study, the data tested are divided into two groups. The first group is bank companies that follow the cost model, while the second group represent bank companies that follow the fair value model. Table 4.4 clarifies that companies that follow the fair value model have a mean score of 0.039 for return on assets and 0.067 for return on equity compared to 0.025 and 0.044 for companies that follow the cost model. This confirms that companies that operate in the bank in Kuwait and use the fair value model have higher profitability ratios than companies that follow the cost model.

Table 5 shows that there was no significant difference in the return on assets score of cost model implementation (M=0.0248, SD=0.0107) and in the return on assets score of fair value model implementation (M=0.0393, SD=0.0193) conditions; t(13)=-1.660, p=0.121, also, there was no significant difference in the return on equity score of cost model implementation (M=0.0444, SD=0.0193) and in the return on equity score of fair value model implementation (M=0.0669, SD=0.0351) conditions; t(13)=-1.422, p=0.179.

Companies that apply international financial reporting standards have a lower equity ratio than companies that do not. An incentive for implementing international financial reporting standards is to strengthen the legitimacy towards lenders, as international financial reporting standards provide increased information sharing. The study's results show that the companies with higher profitability tend to implement international financial reporting standards, where the intention may be to minimize the information gap of lenders and strengthen their legitimacy. However, few companies that apply international financial reporting standards also valuate their properties at fair value. Previous research has highlighted those solid incentives to report banks at fair value are to influence key ratios to avoid violating loan terms.

The study results contradict some previous studies, such as (Dignah, Latiff, Karim, & Rahman, 2017; Strouhal, 2015). Since the companies that report their properties at fair value have strong profitability and thus good ability to pay and should therefore not be close to breaching loan terms. Instead, their incentives may be similar to Yao et al. (2015) describe how companies implement international financial reporting standards to strengthen their legitimacy in the market through increased information sharing with external parties. Spect of Quagli and Avallone (2010) about how companies intend with the application of international financial reporting standards to gain increased confidence from lenders to more easily generate capital injections.

Ghosh, Liang, and Petrova (2019) emphasize that valuation at fair value has had a significant impact on the property companies' financial statements. He has studied listed companies, and of the three he has studied, unrealized changes in value due to fair value measurement accounted for more than 50 per cent of the reported profit.

Table: 4 Group Statistics

	method	N	Mean	Std. Deviation	Std. Error Mean
ROA	Cost method	6	.0248	.01069	.00436
	Fair value	9	.0393	.01933	.00644
ROE	Cost method	6	.0444	.01928	.00787
	Fair value	9	.0669	.03508	.01169

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Table: 5 Independent Samples Test

		Levene's Test for Equality of Variances		t-test for Equality of Means				
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference
ROA	Equal variances assumed	3.829	.072	-1.660	13	.121	-.01448	.00872
	Equal variances not assumed			-1.861	12.734	.086	-.01448	.00778
ROE	Equal variances assumed	2.176	.164	-1.422	13	.179	-.02248	.01581
	Equal variances not assumed			-1.595	12.714	.135	-.02248	.01410

6. Conclusion

Evaluation of firm assets and debt considers one of the main issues within the international financial reporting standards; IAS 40 is a standard within the International Financial Reporting Standards (IFRS). In Kuwait, listed group companies are forced to apply IFRS regulations, while unlisted companies can choose whether to use the standard. Within IAS 40, banks can choose to report their investment according to two principles, either at cost or at fair value. The fair value is defined as the market value of the asset. The market value is determined based on three input levels, where the highest priority is arranged transactions in the banks' primary market. If it is not feasible to determine the fair value based on negotiated transactions, banks may make a subjective assessment to determine the fair value of the property.

On the other hand, compiling the annual report, according to the accounting committee's general advice, reproduce the fair value of the banks' investment in the disclosure note. The fair value must be reported if it can be measured reliably and if it can be produced without unreasonable cost. A bank that complies with IFRS regulations but chooses to write its properties according to the acquisition value must follow the same general advice on disclosure of the fair value of its investment management.

Companies can thus have an agenda behind applying the chosen accounting method to negotiate better agreements, take larger loans to finance other investments or even because people in high positions want to make more money. Even though a firm states in its annual report which accounting method they use, it is not easy to distinguish and understand that it is possible to differentiate between different accounting methods how much an asset is valued on the balance sheet. High market prices thus lead to highly valued assets when applying fair value, affecting the company's earnings. In other words, a market valuation can make companies look stronger in their annual report, and it can be difficult for the public to see where the results come from.

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