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Accounting Conservatism and Profitability of Commercial Banks: Evidence from Jordan*

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Abstract

Accounting conservatism refers to financial reporting guidelines that require accountants to exercise a high degree of verification and utilize solutions that show the least aggressive numbers when faced with uncertainty. Accounting conservatism is a principle that requires company accounts to be prepared with caution and high degrees of verification. This research aims to identify the effect of Accounting Conservatism on Jordanian Commercial Banks' profitability for the period between 2010–2019. To test the study hypothesis, the researcher used an analytical approach to describe the financial profitability of the Jordanian banks. The study was applied to a sample of Jordanian banks during the study period. The results showed that there is an acceptable level of accounting conservatism in the Jordanian commercial banks, and the findings concluded that there is a positive correlation between the Accruals scale and returns on equity, as well as the rate of return on assets. The study recommends conducting more studies using other measures of accounting conservatism on Jordanian banks, in general, to ensure that the results of other studies are similar, and to open opportunities for the investors to further progress, success, and improve competitiveness.

Keywords: Accruals, Return on Equity, Banks, Jordan

JEL Classification Code: M41, O34, G10

1. Introduction

Banks are an essential economic pillar of any country. A financial report (also referred to as a financial statement or finance report) is a management tool used to communicate key financial information to both internal and external stakeholders by covering every aspect of financial affairs. Financial reporting is a standard accounting practice that uses financial statements to disclose a company's financial information and performance over a particular period, usually on an annual or quarterly basis (Wronski & Klann, 2020).

Conservatism principle is the accounting principle that concerns the reliability of the financial statements of an entity. The conservatism principle guides accountants on how to records and recognizes the uncertain outcome of revenues, expenses, assets, and liabilities in financial statements. This principle also intends to ensure that the users who use financial statements receive enough and reliable information as they should be. Several variables can affect the usage of accounting conservatism in financial statements, such as the adoption of a new accounting standard (Santana & Klann, 2016).

The management in any firm or commercial body is responsible for preparing these reports. Financial statement manipulation refers to the practice of using creative accounting tricks to make a company's financial statements reflect what the company wants its performance to look like rather than its actual performance. Companies sometimes commit fraud in their financial statements, misrepresenting the company's financial health to impress investors or hide taxable income. However, following a conservative accounting policy when preparing financial reports can reduce this gap between shareholders and managers or other parties. It is a longstanding principle in financial

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reporting intended to protect users of financial information from inflated revenues and to make sure that all potential liabilities are recorded as soon as they are realized (Sholikhah &Baroroh, 2021).

The adoption of the accounting reservation policy is only part of the measures taken by the firms to ensure the quality and transparency of the real situation of companies and institutions. The financial performance contributes to providing important and useful information in the areas of control, planning, and decision-making, and for the financial statements to achieve their objectives, they must be accurate and even presented in time (Kian et. al, 2021).

Accordingly, the mechanism of optimal utilization of financial resources is one of the challenges faced by bank managers, while the evaluation and analysis of the financial performance of banks aim to provide financial information related to the bank's activity and reveal its weaknesses and strengths. The current research studies the impact of applying the accounting conservatism policy on financial performance for commercial banks in Jordan. During the past few decades, the Jordanian banking sector was the main financier for various groups of Jordanian society, including government, individuals, and companies, and the Jordanian banking sector was able to become a pioneer for economic development in Jordan.

In light of the above, this study came to examine the impact of applying the accounting conservatism policy on the financial performance of Jordanian commercial banks represented by the rate of return on assets and the rate of return on equity. This study aims to provide evidence on the application of the reservation policy, accounting and its effect on the financial performance of Jordanian commercial banks, and providing evidence that sheds light on aspects of concern to the financial authorities in the field of commercial banks.

2. Literature Review

Chan et al. (2009) investigated the economic consequences of different dimensions of accounting conservatism: ex-ante (balance sheet or unconditional) conservatism and ex-post (earnings or conditional) conservatism. It is argued that the two dimensions of conservatism convey different information to the market about the quality of accounting numbers and have different associations with equity investors' required rates of return. The findings indicate that ex-ante conservatism is associated with a higher quality of accounting information and lower costs of equity capital and that ex-post conservatism is associated with lower quality of accounting information and higher costs of equity capital.

Lara et al. (2011) tested the association between conditional conservatism and the cost of equity capital. Conditional conservatism imposes stronger verification requirements for the recognition of economic gains than economic losses, resulting in earnings that reflect losses faster than gains. This asymmetric reporting of gains and losses is predicted to lower firm cost of equity capital by increasing bad news reporting precision, thereby reducing information uncertainty and the volatility of future stock prices). Using standard asset-pricing tests, we find a significant negative relation between conditional conservatism and excess average stock returns over the period 1975–2003. This evidence is corroborated by further tests on the association between conditional conservatism and measures of implied cost of capital derived from analysts' forecasts.

Abed et al. (2012) investigated the level of conservatism in accounting policies and examined its effect on earnings management for a sample of 259 Jordanian Manufacturing companies during the period 2006–2009. The results indicated that there are differences in the level of conservatism between companies. Furthermore, the results of this study revealed that conservatism and size are negatively related to earnings management, whereas performance was positively related to earnings management.

Hamdan (2011) tested the effect of accounting conservatism on the fair value of Jordanian industrial companies during the period 2006–2013, based on a sample of 30 Jordanian industrial corporations. The results showed a variation between the extent of practicing the accounting conservatism by the industrial Jordanian companies and the lower level of accounting conservatism in general. Results also indicated the existence of clear diversity in the size of the Jordanian industrial corporates and a variation in the liability percent and the significant difference in their profits and distributed profits ratios. However, in general, their fixed assets ratio is closer. The study concluded, through the use of joint regression, the existence of an inverse relationship between the accounting conservatism and the fair value; where the low accounting conservatism plays a major role in the fair market value of the Jordanian industrial companies. This confirms the negative relationship between the concept of accounting conservatism and fair value, which reflects implicitly the relationship between the conservatism and the historical value approach.

Alkurdi et al. (2017) investigated the effect of ownership structure on accounting conservatism for financial and manufacturing Jordanian companies. The results were that there was a positive and significant relationship between accounting conservatism and institutional ownership but the concentration of ownership had a negative relationship with accounting conservatism. Alhenaoi (2018) aimed to test the effect of the level of accounting reservation, in its two types, conditional and unconditional, on the cost of capital, both of which are financing by ownership and financing by borrowing. Using multiple regression analysis, the study results showed a negative but not significant relationship between conditional reservation and the cost

of owner financing. The results of the study also showed a negative and significant relationship between unconditional reservation and the cost of owner financing.

Nam (2020) found that the first analysts' forecasts for the future quarter are associated more with cash-driven prediction, which is future earnings prediction based on only current cash flows. The result implied that analysts use cash flows more in their first forecasts. Future earnings prediction based on current cash flows and current accruals or current earnings is associated more with the last analysts' forecast before future earnings are announced, suggesting that over time, analysts incorporate accruals information into their forecasts. It was hypothesized that analysts have fixated on cash-driven prediction because the accruals information among firms reporting losses in the current quarter is less useful to analysts in making future forecasts. The results showed that the stronger association documented between the first analyst forecast and cash-driven prediction exists only for the sample of firms reporting losses.

Haider et al. (2021) showed that managerial ability is positively associated with accounting conservatism and supported the notion that high-ability managers apply conservatism in accounting because it benefits the stakeholders and firm. Ozcan (2021) studied the effect of corporate governance on accounting conservatism on non-financial companies in Istanbul. The findings were that board independence, firm size, institutional ownership, and board size had a positive relationship with accounting conservatism. On other hand, leverage had a negative relationship with accounting conservatism.

3. Theoretical Framework and Hypotheses

Accounting conservatism requires a high degree of verification before a company can make a legal claim for any profit (Beyer & Hinke, 2020). The general concept is to take into account the worst-case scenario of the company's financial future. Uncertain liabilities are to be recognized as soon as they are discovered. In contrast, revenues can only be recorded when they are assured of being received (Zhong & Li, 2017).

Generally Accepted Accounting Principles (GAAP) insist on a number of accounting conventions being followed to ensure that companies report their financials as accurately as possible. One of these principles, conservatism, requires accountants to show caution, opting for solutions that reflect least favorably on a company's bottom line in situations of uncertainty (Sugiarto & Fachrurrozie, 2018).

Assets and revenues are intentionally recorded in numbers that are likely to be understated. On the other hand, liabilities and expenses are over represented. If there is doubt about incurring a loss, accountants are encouraged to record it and increase its potential impact. Conversely, if there is a possibility that the company will realize gains, it is advisable to ignore them until they happen (Ozcan, 2021).

Accounting conservatism is not intended to manipulate the dollar amount or timing of reporting financial figures. It is a method of accounting that provides guidance when uncertainty and the need for estimation arise: cases where the accountant has the potential for bias (Al Ani & Chong, 2021). The principle of prudence or accounting prudence sets the rules when choosing between two alternatives to financial reporting (Khalilov & Osma, 2020).

Accounting conservatism may be applied to inventory valuation. When determining the reporting value for inventory, conservatism dictates the lower historical cost or replacement cost is the monetary value. Estimations such as uncollectable account receivables (AR) and casualty losses also use this principle. If a company expects to win a litigation claim, it cannot report the gain until it meets all revenue recognition principles. However, if a litigation claim is expected to be lost, an estimated economic impact is required in the notes to the financial statements. Contingent liabilities such as royalty payments or unearned revenue are to be disclosed, too (El-Habashy, 2019).

Accounting conservatism is most stringent in relation to revenue reporting. It requires that revenues are reported in the same period as related expenses were incurred. All information in a transaction must be realizable to be recorded. If a transaction does not result in the exchange of cash or claims to an asset, no revenue may be recognized. The dollar amount must be known to be reported. (Sholikhah & Baroroh, 2021).

In total, reporting profits too low and losses too high means that accounting conservatism will always report lower net income and future financial benefits. Painting a pessimistic picture of a company's financial statements brings several benefits (Ozcan, 2021).

On other hand, International Financial Reporting Standards rules, such as an accounting reservation, are often subject to interpretation, meaning that some companies will always find ways to manipulate them to their advantage. One of the other problems in accounting conservatism is the possibility of the revenue being carried over. If the transaction does not meet the reporting requirements, it must be reported in the next period, and this leads to underestimating the value of the current period and overstating the value of future periods. This makes it difficult for the organization to track business processes internally (Alkurdi et al., 2017).

In summary, the following hypotheses are formalized because accounting conservatism is a principle that requires the firm company financial reports to be prepared with caution. Gains can only be recorded when fully realized (Dang et al., 2020), while all potential expenses are recorded when discovered. Therefore, the study hypotheses are:

H1: *Accruals scale does not have a significant impact on return on assets.*

H2: *Accruals scale does not have a significant impact on earnings per share.*

H3: *Accruals scale does not have a significant impact on return on equity.*

4. Research Methodology

In this study, the researcher relied on the descriptive and analytical approach that describes the reality of financial performance and then analyzes this reality and studies its characteristics to know the effect of applying accounting conservatism on the financial performance of commercial banks in Jordan. Thus is based on the observation, which is based on the theoretical framework and the results of the analysis of the financial statements, will be adopted. The study also used a statistical program (SPSS v.22) to analyze and test the study data.

5. Research Results

5.1. Descriptive Analysis

Table 1: Skewness, Kurtosis

Variable	Skewness	Kurtosis
Earnings per share	1.41	5.34
Return on Assets	–0.34	3.03
Return on Equity	–0.11	2.82
Accruals Measurement	–1.74	6.48

5.2. Bivariate correlation

From Tables 1, 2, and 3, a correlation exists between study variables. The results indicate that the relationships between the study variables, as we note the existence of relationships between the independent study variables (rate of return on assets, rate of return on equity, and earnings per share) with the dependent study variable.

5.3. Regression Analysis

The researcher tested the hypotheses of the study to extract the results and discuss them, using a simple regression test to test the effect of the independent variable on the dependent variable as follows:

Table 4 shows the results of the simple linear regression analysis of the effect of the accruals variable on the return on assets variable. Also, the value of (t) extracted for the regression model reached (15.7) at the level of significance (0.000), which is less than the level of significance on which the current study relies as a decision rule (5%).

As a result, it becomes evident to reject the null first hypothesis and accept the alternative that states: "Accruals scale does have a significant impact on return on assets of Jordanian commercial banks." Besides, banks can benefit from what is called economies of scale as they work to increase profits and reduce costs, as they are more diversified in their activities. This works to diversify and increase sources of income, as banks are large in terms of capital and the number of branches can provide a large number of financial services to their customers and thus activate more Earnings.

Table 2: Descriptive Measures

Measure	Mean	Standard Deviation	Min	Max
Earnings per share	0.237	0.205	0.007	1.01
Return on Assets	0.013	0.005	–0.002	0.025
Return on Equity	0.087	0.039	–0.014	0.169
Accruals Measurement	17.522	1.633	11.527	19.921

Table 3: Correlation Matrix

Variable	Earnings per Share	Return on Assets	Return on Equity	Accruals
Earnings per share	1	0.86**	0.293	0.15**
Return on Assets		1	0.295	0.168**
Return on Equity			1	–0.21**
Accruals Measurement				1

*Significant at the 0.05 level. **Significant at the 0.01 level.

Table 4: Regression Analysis Results for the First Hypothesis

Durbin Watson	*R*	Sig. *T*	*T*	Dependent Variable	Independent Variable
1.96	0.17	0.00	15.7	Return on assets	Accruals

Table 5: Regression Analysis Results for the Second Hypothesis

Durbin Watson	*R*	Sig. *T*	*T*	Dependent Variable	Independent Variable
1.89	–0.18	0.00	8.1	Earnings per share	Accruals

Table 6: Regression Analysis Results for the Third Hypothesis

Durbin Watson	*R*	Sig. *T*	*T*	Dependent Variable	Independent Variable
1.99	0.15	0.00	18.4	Return on equity	Accruals

Table 5 shows the results of a simple linear regression analysis of the effect of the accruals variable on earnings per share. Also, the value of (t) extracted for the regression model reached (8.1) at the level of significance (0.000), which is less than the level of significance (0.05) on which the current study relies as a decision rule (5%).

Because of the foregoing, it becomes evident to reject the second null hypothesis and accept the alternative one, which states: "Accruals scale does not have a significant impact on earnings per share." This can be explained by the strict policies of the Central Bank of Jordan owing to the economic and political conditions of neighboring countries. This reflects the inability of Jordanian commercial banks to develop competition in terms of increasing credit facilities, due to the increase in credit interest and the increase in conservative policies pursued by commercial banks in this field, which causes the reduction of the profitability of banks. According to the conservatism principle, earnings reflect bad news more quickly than good news.

Table 6 shows the results of a simple linear regression analysis of the effect of the accruals on the return on equity. Also, the value of (*t*) extracted for the regression model reached (18.4) at the level of significance (0.000), which is less than the level of significance (0.05) on which the current study relies as a decision rule (5%).

Because of the foregoing, it becomes evident to accept the alternative hypothesis that states: "Accruals scale does have a significant impact return on equity of Jordanian commercial banks. This is due to the large discrepancy between the profitability of banks and business by volume of capital.

5.4. Additional Statistical Tests

In the presence of heteroscedasticity, most of the researchers use the GMM estimation technique (Ahmed et al., 2021). The researchers used the GMM system (generalized method of moments) to investigate the endogeneity issue to ensure that the endogenous association does not drive the results between dependent and independent variables (Bennouri et al., 2015). This provides consistent and efficient coefficient estimators, especially when testing controls for small panel data and time-invariant fixed effects that may bias the estimation of the dependent variable, and addresses issues related to autocorrelation, heteroscedasticity, and omitted variables. The findings show similar results too and assert that the results are robust even after controlling for the endogeneity concern (Luc, 2018).

Finally, the accuracy of the models is tested using Sargan tests and autocorrelation. In all models, the autocorrelation 1 test gives evidence for negative first-order serial correlation. Also, the second-order serial correlation is not found as the autocorrelation 2 test indicated these findings do not violate the regression models estimation (Al-Fayoumi et al., 2010).

6. Conclusion and Recommendations

The conservatism principle is the general concept of recognizing expenses and liabilities as soon as possible when there is uncertainty about the outcome, but only recognize revenues and assets when they are assured of being received. Thus, when given a choice between several outcomes where the probabilities of occurrence are equally likely, you should recognize that transaction resulting in a lower amount

of profit, or at least the deferral of a profit. Similarly, if a choice of outcomes with similar probabilities of occurrence will impact the value of an asset, recognize the transaction resulting in a lower recorded asset valuation.

Accounting conservatism establishes the rules when deciding between two financial reporting alternatives. If an accountant has two solutions to choose from when facing an accounting challenge, the one that yields inferior numbers should be selected.

The present study aims to identify the impact of the accounting conservatism policy on the financial performance of Jordanian banks based on the reports and auditors of the banks under study. The current study focused on many factors that indicate accounting reservation, by measuring the financial performance of banks through the accounting conservatism scale, which is a measure of accruals to measure the financial performance, namely: the return on assets measure, the return on equity measure, and the earnings per share measure.

The researcher believes that accounting conservatism is one of the policies associated with Jordanian commercial banks. The results of the current study indicated that there is a direct relationship between the scale of accruals and the rate of return on assets, that is, the higher the scale of accruals, the higher the rate of return on assets. The researcher attributes this result to the efficiency of bank management in the use of assets and the widespread of branches and buildings and the provisions of the Central Bank of Jordan for policy accounting conservatism. Also, this result contradicts the studies of Chan et al. (2009) and (Banker et al, 2016) who indicated that there is an inverse relationship between the accounting conservatism policy and the low cost of capital.

The results also indicated that the relationship between accounting conservatism and return on equity was also positive. The higher the scale of accruals, the higher the return on equity. The researcher believes that this is due to the extent of the efficiency of banks in generating profits in terms of the size of the number of shares because of new share issues, or stock split, or from during the bonus shares distribution. This result contradicts the result of the study of Lara et al. (2011) who indicated the existence of a real inverse relationship between accounting reservation and property rights, and also a study by Artiach and Clarkson (2013) who indicated an inverse relationship between accounting conservatism and return on equity.

Lastly, the results of the current study showed that the relationship between the accruals scale and the earnings per share variable was negative. In the sense that the relationship between the two variables was inverse, so the higher the scale of accruals, the lower the value of earnings per share. The researcher attributes the reasons to strict policies adopted by Jordanian commercial banks in the field of granting credit facilities in addition to other factors such as corporate structuring, high unemployment rates, and others. This result contradicted the result of the study by Francis et al. (2013) who showed a real positive relationship between conservatism and the performance of companies' shares.

The management of Jordanian commercial banks must find a way to implement the accounting conservatism policy without prejudice to or decline in the profits and returns of the bank or harm to the rights of shareholders. Jordanian commercial banks should seek the assistance of economic experts who can provide advice and solutions to increase their profit rate, open opportunities for investors to further progress, success, and improve competitiveness.

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