Abstract

The objective of this study is to examine the value relevance of accounting earnings and book value of equity in explaining stock price. The study investigated whether bias in accounting influence earnings response coefficient and book value of equity coefficients. The study shows that accounting earnings and book value of equity are positively associated with stock price. Accounting earnings and book value of equity are useful to explain stock price changes. The results also shows that earnings response coefficient is smaller in the firms that have both conservative accounting or liberal accounting.

Keywords: earnings response coefficients, book value response coefficients, and bias in accounting.

1. Introduction

Financial statements that are published by an entity must actually disclose the condition of the entity, so that give benefit to public. Information that is useful for decision making should have value relevance. One of the indicator that an accounting information is relevant is there is a reaction of investor at the time of announcement of information that can be observed from the existence of move. The focus of this research is the examination of the coefficients related to accounting earnings and equity book value information. This coefficients measure share price or equity market value response to an information which implied in accounting earnings and equity book value.

Studies which examine earnings response coefficient (ERC) find that ERC vary by cross-section. The variation can be explained by some factors like risk, growth, earnings persistence, and interest rate (for example Collins and Kothari, 1989; Easton and Zmijewski, 1989). Studies concerning variation of equity book value coefficient also have started to get attention which is generally done with testing the combination
of earnings coefficient and book value coefficient (Barth et al, 1998; Burgstahler and Dichev, 1997; and Ou and Sepe, 2002). This research tries to find whether bias in accounting influence earnings response coefficient and equity book value response coefficient.

2. Literature Review and Hypothesis

2.1. The Value Relevance

In literature, an accounting numbers is said to have a value relevant if it has a predicted relationship with market value of equity (Amir et al, 1993; Beaver, 1998). For researchers, the purpose of testing the value relevance is expanding knowledge of the relevance and reliability of accounting numbers that are reflected in equity values. The value relevance is the empirical operationalization of the relevance and reliability criteria. An accounting numbers will be relevant, have significant relationship with stock price, if the accounting numbers reflect the information that relevant to investors in valuing a firm and are reliably measured to be reflected in stock prices (Barth et al, 2001).

Statistical association between accounting data and stock market value is used by Lev and Zarowin (1999) to assess the usefulness of financial information for investors. This association reflect the action of investors, while the other measure such as questionnaires or interviews, simply reflect investors opinions and beliefs.

2.2. The Value Relevance of Accounting Earnings and Book Value of Equity

Various study have proved that accounting earnings relate to share price (Ball and Brown, 1968; Beaver, 1968; Beaver et al, 1979; Kormendi and Lipe, 1987; Lipe 1986; Collins and Kothari, 1989). Some studies also indicate that asset and liabilities relate to share price (Landsman, 1986; Amir, 1993; Francis and Schipper, 1999).

The examination of value relevance of the combined of accounting earnings and book value of equity that is conducted by some researchers is motivated by result of the study of Ohlson (1995) and Feltham and Ohlson (1995, 1996). Ohlson’s study (1995) is used as theoretical base of the relation of book value of equity and earnings and share price. This study is relied on the following linear regression (price-levels):

\[ P_{jt} = \alpha_0 + \alpha_1 B_{jt} + \alpha_2 E_{jt} + \epsilon_{jt} \]

where \( P_{jt} \) is share market price of firm j at time t, \( B_{jt} \) is book value of equity of firm j at time t and \( E_{jt} \) is earnings of firm j at time t. Ohlson (1995) have given understanding framework to interpret above mentioned regression coefficient estimation (\( \alpha_0, \alpha_1, \alpha_2 \)).

The examples of research which is affected by both study which use combined of earnings and book value are Barth et al. (1998), Burgstahler and Dichev (1997), Collins et al. (1997), Collins et al. (1999), Francis and Schipper (1999), Ely and Waymire (1999) and Ali and Hwang (2000). The finding of these studies indicate that book value and earnings represent factor which significantly influences share price.
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