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Owners' equity and accounting information relevance

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Abstract

The paper examines the influence of equity ratio on the value relevance of earnings and book value for Jordanian industrial companies from 1992 to 2002. The findings show that equity ratio significantly influenced the value relevance of individual book value but not earnings. In their combination, the paper indicates that share prices respond more to book value than earnings. Our findings might increase the valuation practices understanding of financial statements users and provide fundamentals for future studies that aim to examine our hypotheses in more details.

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Keywords: Share price; value relevance of earnings and book value; owners' equity; Jordan.

1. Introduction

Valuation research has been extended to include different accounting and other information based on the conceptual framework proposed by Ohlson (1995). This study is motivated by the prior valuation studies that examined the influence of owners' equity as other information on the value relevance of accounting information (Davis-Friday, Eng, & Liu, 2006; Anandarajan and Hasan, 2010; Shamki, 2012). Definitively, through those few studies, although the value relevance of accounting information is found to be influenced by ownership structure

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but it is not widely proven, so this claim needs more confirmation and extension. Beside this, the influence of equity ratio as a proxy to owners' equity, using price model, has not been well examined in previous studies.

Does owners' equity influence the value relevance of earnings and book value? This question is addressed using price model for 18 Amman Stock Exchange (ASE) industrial companies for the period 1992-2002. The paper objects to examine the influence of equity ratio on the value relevance of accounting information to expand valuation research and fill the gap in literature by adding further evidence from Jordan as an emerging stock market. Tracing this influence might increase the valuation practices understanding and support the financial statements users in well relating firm's accounting and other information and in turn alleviating the asymmetric information.

2. Literature review

One positive accounting theory proposition is that managers and shareholders are rational to maximize their utilities. Firm's management is more likely to choose accounting procedures that report high earnings for current period to increase present value of its bonuses. Since the management knows more about a firm than shareholders, information asymmetry forms a main problem. According to agency theory, Fig. 1 illustrates the relationship between firm's management and its shareholders.

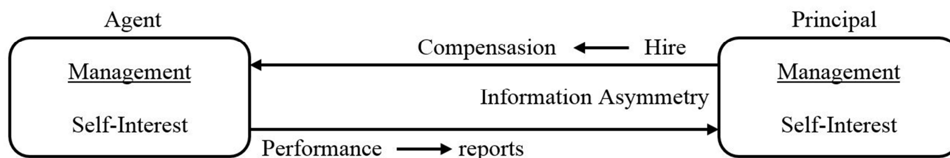

Fig. 1. Management-Shareholders Relationship

It is found that a higher degree of imbalanced information makes it more difficult for shareholders to monitor managers, and firms with high (low) asymmetric information are associated with lower (higher) values (Jiraporn, Miller, Yoonc & Kim, 2008). To alleviate information asymmetries, disclosing more accounting information is essential for capital market efficiency and fairness in case all shareholders will have access of relevant information (Benston, 1973). Relevant information reflects firm performance then its equity market value. The relationship between accounting information and market value of firm equity is explained by valuation theory to indicate the value relevance of the accounting information as illustrated in Fig. 2. Therefore, disclosing relevant information by firm's managers could reduce the agency gap (Debreceny, Gray, & Rahman, 2002).

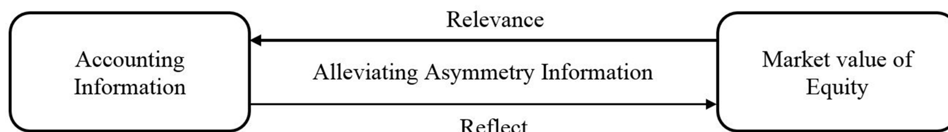

Fig. 2. Valuation Theory

It is found that ownership equity has positive relationship with price-to-earnings (Zeckhauser & Pound, 1990) and market-to-book value of equity (Pedersen & Thomsen, 2003). Reporting relevant information can attract more shareholders and in turn significantly and positively influenced firm's share price evaluation. Therefore, increasing equity motivates firms' managers to present more relevant information that reflects firm performance and in turn increases its value. As a reaction, valuation models have been extended to indicate the influence of other information on the value relevance of accounting information by interacting them in the model as illustrated in Fig. 3.

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