International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

The Conceptual Framework of Value Relevance of Accounting Information

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ABSTRACT

Every stakeholder has the right to be well informed about the financial status and soundness of a company before taking any kind of financial decision. This purpose is served by financial statements of a company. Financial statements are considered to be value relevant in terms of both relevance and reliability, as they help a lot in decision making, and in raising stakeholders' trust on any company. Present study elaborates the conceptual framework of value relevance of accounting information. Fundamental, Prediction, Information and Measurement are the widely used concepts relating to the financial statements' assessment.

Keywords: Accounting Information, Book Value of Equity, Cash Flows, Earnings, Value Relevance

1. INTRODUCTION

The basic foundation of value relevance research lies in the fact that listed companies inform various stakeholders' about different parameters of their companies through financial statements. This act is termed as financial reporting, and every stakeholder intends information presented therein to be value relevant (Hendriksen & Breda, 1992). A value relevant information must possess the qualities of being relevant and reliable (Barth *et al*., 2001). Relevant information helps the users in prediction, confirmation or correction of their decisions. Reliable information can be trusted upon without doubt of any error or bias (FASB, 1976). Below mentioned are the popularly adopted definitions of value relevance:

"an accounting figure/ratio is value relevant if it has the significantly strong predicted association with the stock prices and stock market indicators such as price-earnings (P/E) or price to book (P/B) ratios"

Amir *et al*. (1993)

"value relevance research investigates the association between a security price (return) as a dependent variable and a set of independent accounting variables (e.g., earnings, book value and cash flows). An accounting variable that is found to have a significant statistical association with the dependent variable is considered value relevant from an investor's perspective"

Beaver (2002)

"value relevance is termed as the ability of financial statement information to capture and summarise company's value"

Beisland (2009)

All above mentioned definitions are based on the facts that the accounting information is value relevant, if it enables the users in correctly assessing the value and performance of a company. Also, value relevance studies assess the association amongst share prices or returns as a dependent variable and earnings, book values of equity, and cash flows as independent variables.

2. THE CONCEPTUAL FRAMEWORK OF VALUE RELEVANCE

Different studies have highlighted different perspectives on value relevance on the basis of varied market assumptions, and approaches. All these perspectives contribute to the conceptual framework of the value relevance, and hence are explained below:

I. The Fundamental Perspective

This perspective focuses on the usage of the accounting information in equity valuation, wherein, the information generates abnormal returns. Studies like Lakonishok *et al*., 1994; Chan *et al*., 1996; Nilsson, 2003, have followed fundamental perspective.

II. The Prediction Perspective

This perspective is associated with fundamental perspective wherein accounting information is considered to be value relevant if it helps in predicting future earnings, dividends, or cash flows (Francis & Schipper, 1999). Some studies have applied this perspective for predicting future earnings and also for seeing that whether such research predicts abnormal future returns (Lev & Suogiannis, 1996; Nilsson, 2003; Ou & Penman, 1989, Svensson & Larsson, 2009).

III. The Information Perspective

This perspective examines the association between accounting variables and share returns or prices, i.e., capital market reactions to public disclosures such as announcements relating to earnings, company's growth, microeconomic or macroeconomic variables. Studies like Anderson (1975); Ball & Brown (1968); Benston (1967) have applied this perspective. It focuses on a single-person decision theory, where investor predicts performance of a company in future for investment decisions by relying on efficient securities market theory. It is also stated that accountant should provide useful financial statement information to facilitate investors in decision making (Beaver, 1973). Ijiri (1975) and Christensen & Demski (2003) emphasized the stewardship and information content roles of accounting and recognized its out-of-equilibrium role in ensuring managerial actions. Ijiri (1975) studied the composition of historical cost accounting and compared it with other valuation methods with respect to accountability, performance measurement, and economic decisions. Christensen & Demski (2003) suggested two perspectives of accounting objectives, i.e., the value school based on wealth measurement and the information content school based on measuring and disclosing informative events and considered information based perspective as the most logical objective of accounting.

IV. The Measurement Perspective on Value Relevance

This perspective is based on the theoretical base of equity valuation models (Ohlson, 1995; Beisland, 2009). Amir *et al*. (1993) firstly used 'value relevance' relating to information content of accounting figures. Value relevant information shows a significant association of stock prices with price-earnings or price-book ratios. Corporate value can be shown as a linear function of EPS, BVPS, and other relevant information (Ohlson, 1995). The value relevance literature provides useful insights for standard setting process. Such studies determine usefulness of accounting information to investors in valuing a company's equity (Barth *et al*., 2000). It has also been observed that value relevance of accounting numbers has shown declining trend in mature markets and increasing trend in emerging markets (Bao & Chow, 1999; Negah, 2008). Antle *et al*. (2007), and Chang *et al*., (2008) stated that majority of the value relevance studies have earlier focused on financial accounting standard setting which now has been shifted to the concepts, and reassessment of wealth measurement. Francis & Schipper (1999) have provided four different interpretations with respect to value relevance. First interpretation states that financial information is value relevant when it influences stock prices by capturing intrinsic value towards which stock prices drift. Second interpretation states that it includes the variables used in a valuation model or assists in predicting them. Third interpretation observes that it changes stock prices because it causes investors to revise their expectations and the Fourth interpretation states that there is a statistically significant association between financial information and equity market value. The fourth explanation is most generally used while third interpretation matches with the information perspective stating that information is value relevant if has information content.

Value relevance studies can be further bifurcated into 'event studies' or 'association studies'. Event studies examine the impact of an event on the security prices or trading volumes over a short period of time (Kothari, 2001). Such studies, thus determine whether the accounting information of interest gives new information to investors, which is a test of their information content, as evident by price reactions (Holthausen & Watts, 2001). The reaction of investors to the release of financial information is evident by their capital market transactions (Beaver 2002). Studies adopting the information perspective of value relevance generally employ event study methodology. Information content studies assume that equity markets are semi-strong efficient, implying that share prices fully impound all publicly available information in an unbiased manner as it is released (Deegan & Unerman, 2006).

Association studies look at the relationship between accounting numbers and market variables like share prices or returns, over a long period of time. Under measurement view, financial information is value relevant if it captures or summarizes the information actually used by investors, by analyzing the association of market based metrics with accounting numbers over long-time windows (Francis & Schipper, 1999). Association studies are further classified as 'relative association studies' which compare the relationship between fundamental accounting numbers and stock market value across time or subsamples, and 'incremental association studies', which investigate the ability of accounting numbers to provide some additional information (Holthausen & Watts, 2001). Both studies vary in their measure of value relevance. Relative association studies measure value relevance based on the explanatory power of the model, while in incremental association studies magnitude of the coefficient on the variable of interest is used to measure value relevance. The accounting number is value relevant if its coefficient is significantly different from zero (Rozendal, 2012).

3. SUMMARY

Value relevance is a basic attribute for measuring quality of accounting information. It is considered as the most important concept even more important than the concepts of timeliness or conservatism. Value relevance is covered under market based accounting research which primarily focuses on statistically assessing the value relevance of accounting information. Present study highlights the conceptual framework of value relevance of accounting information given in financial statements.

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