The Value Relevance of Accounting Information in Times of Crisis: An Empirical Study

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ABSTRACT

The financial crisis started in 2007 with the credit crunch persists until today in the form of the European debt crisis. The main focus of this paper is the relevance of financial statements in determining firm market value in such times. The work contributes to this research stream as one of the earliest studies probing into the effects of the credit crunch and the euro-debt crises. This paper examines a sample of firm year observations from 2003 to 2011 of companies listed in the Amsterdam Euronext exchange. It focuses on the relation between market values and both book values and net income measures. The findings suggest that the combined explanatory power of the independent variables decreases in the years marked as crisis years. Net income leads to less value relevance highlighting the importance of book values. Incremental explanatory power of book values increases during the credit crunch, and decreases afterwards.

Keywords: Accounting Information, Financial Crisis, Financial Statements, Market Value, Value Relevance

DOI: 10.4018/ijcfa.2014070104
1. INTRODUCTION

In 2007 the sub-prime crisis unfolded and took hold of the capital markets in 2008 with the bankruptcy of Lehman Brothers (Sorkin, 2008). Financial institutions were majorly involved in complex financial transactions that utilized bad mortgages as collateral. With the bursting of the US housing bubble, investments quickly lost their value and financial institutions around the globe were reported to have written down a total of $750 billion by November 2008 (IMF, 2009). This led to a worsening in the solvency of banks. Particularly European banks operating under Basel saw their banking capital melting away, leaving little credit available for businesses and households (Coy, 2009). This caused a slowing down of the world economy. Add a fierce rise of prices for oil and food in the same period, and you have a recipe for global crisis (IMF, 2009).

In Europe, the crisis continues to this day (OECD, 2012). After European governments provided bail-out packages to banks that were “too big to fail”, the ensuing economic crisis drove increases in government debt and budget deficits (DNB 2010). This in turn led to problems with government credit ratings, causing their cost of capital to rise, which made it harder for the associated countries to (re-) finance their debts and cover their budget deficits (Blundell-Wignall & Slovik, 2012). Countries like Greece are facing trouble refinancing their debts with interest rates soaring and threatening to pull down other countries in the case of a default (The Economist, 2010). Conditions could further spiral downward as banks have to write down government bonds (Kirchfeld et al., 2012), causing the banking capital to shrink even more reducing thus the credit available to businesses and households. This could lead to more bail outs from governments that may not have enough room to do so.

Publicly listed companies experience this situation by troubles they face in accessing the capital necessary for investments (Goodman, 2008), or by a general business decline and the economy slow down (IMF, 2009). Financial performance reflected in the annual accounts decreases, leading often to the reporting of losses. Investors become wary and are less willing to invest in risky endeavours. The crisis described above sets the stage for numerous debates and studies. This study attempts to link the still ongoing crisis to accounting theory and, more specifically, the usefulness of audited financial statement reports.

Provided that the Generally Accepted Accounting Principles impose adequate guidelines to display economic reality, audited financial statement reports become an important instrument for investors. Financial statements provide information on firm’s assets, liabilities and their ability to effectively utilize the former in order to generate income. This information allows investors to determine the value of a company as well as its potential to generate profits in the near future (Palepu et al., 2003).

The value relevance of financial statements can be measured in various ways. Prior literature focuses on trade volume and price levels (Beaver, 1968), cashflows as performance measure (Dechow, 1994) or even negative income numbers (Hayn, 1995). However, consistent with Barth et
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