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The value relevance of earnings in a transition economy: The case of Romania

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Abstract

We investigate the value relevance of earnings on the Bucharest Stock Exchange. We find that the association between accounting earnings and stock returns is comparable to the levels reported by studies conducted on more mature markets, and that it is higher for securities issued by small companies. Excluding losses from the analysis increases the value relevance of earnings, which confirms the transitory nature of negative earnings, already documented by prior studies. We also find that the regression coefficient of earnings changes is negative and we provide evidence consistent with the hypothesis that it is a consequence of the relative inefficiency of the market. Finally, the "prices lead earnings" hypothesis formulated for more mature markets is not supported by our results.

Keywords: Value relevance; Transition economy; Eastern and Central Europe; Romania; Hyperinflation

1. Introduction

There is an abundant literature on the value relevance of accounting data, defined as the ability of accounting figures to capture or summarize information that affects firm value (Hung, 2001). Value relevance is traditionally viewed as a synonym for high correlation with market data: the more accounting data correlate to market prices or returns, the more "value relevant" they are considered to be.

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The conclusion of most empirical studies is that the association between earnings and contemporaneous security returns is relatively low, which suggests that reported earnings do not provide good summary measures of the events incorporated in stock prices during the reporting period (Dumontier & Raffournier, 2002). These studies are generally conducted in large and mature capital markets. Only a small number of authors have investigated the case of small or emerging markets. Among the exceptions in Europe are Vafeas, Trigeorgis, and Georgiou (1998), and Kousenidis, Negakis, and Floropoulos (2000) who study the Cyprus and the Athens stock markets, respectively.

There is also little evidence on the value relevance of accounting data in transition economies. Several studies have investigated the case of China (Bao & Chow, 1999; Chen, Chen, & Su, 2001; Chen, Gul, & Su, 1999), but little is known about value relevance on the new stock exchanges that appeared in Eastern and Central Europe after the accession of these countries to a market economy. Nevertheless, such emerging markets should attract the attention of investors who, after they have diversified their portfolios with stocks traded on mature markets, are in search of new investment opportunities.

Despite its common recent history, Eastern and Central European countries cannot be seen as a homogenous group. Each country has peculiarities stemming from its pre-communist history and cultural influences. Moreover, there is considerable variation in the level of economic development across countries that may influence the rapidity of the transition to a market economy.[1] As a consequence, the experience in a particular country cannot be generalized to the whole group and it is necessary to replicate analyses in these different environments to have a clear picture of the situation in Eastern and Central Europe.

For the time being, value–relevance studies have been conducted in Poland (Dobija & Klimczak, 2007; Gornik-Tomaszewski & Jermakowicz, 2001), the Czech Republic (Hellström, 2006; Jindrichovska, 2001) and the Baltic states (Jarmalaite Pritchard, 2002). We are not aware of similar research in other markets of Eastern and Central Europe although all transition countries now have a stock exchange.[2] The aim of this paper is to partially fill this gap by considering the case of Romania.

As most markets created in Europe after the collapse of the former communist system, the Bucharest Stock Exchange (BSE) is characterized by a small number of listed companies, low trading volumes, and relatively few disclosure requirements. But its emergence and development also took place in a political and economic context significantly different from those that prevailed in other countries of Eastern and Central Europe. One of these specificities is the particularly high level of inflation that characterized the Romanian economy in the 90s.[3] Another difference with neighboring countries is that for a long time the Romanian government focused more on political issues than on decisions that would have permitted the economic change to take place (King, Beattie, Cristescu, & Weetman, 2001). As a result, the economic development of Romania lagged

[1] In 2006 for example the Gross Domestic Product per capita ranged from € 15,200 for Slovenia to € 2500 for the Republic of Macedonia (Source: Eurostat).

[2] Stock exchanges also exist in Hungary, Romania, Bulgaria, Slovenia, Slovakia, Croatia, Serbia, Bosnia-Herzegovina, Montenegro, Macedonia and Moldova.

[3] From 1990 to 1999, the average annual inflation rate was 110.9% (source: Romanian National Institute of Statistics).