

DOCTORAL THESIS

Firm equity decision, disclosure rule and corporate transparency, a revisit of market's use of earnings information

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Abstract

This paper extends the scope of Earnings per share (“EPS”) studies by incorporating Bushman et al. (2004)’s conceptual framework of corporate transparency to illustrate how the disclosure requirement of an accounting rule governing EPS could have far-reaching effects on the information environment in US. Informed participants are having a keener edge over average investors in using EPS as a guide to investment value.

EPS signals a summary measure of firm performance to market participants. The market reactions to EPS and change in per share earnings provide a distinct opportunity to gauge the informativeness of earnings. The information role will nevertheless derail whenever there is an equity change. The accounting rule stipulates the use of a theoretical construct, the weighted average number of shares, in the denominator for EPS, which the average investor is unable to interpret as the number of shares at the reporting date is the actual, not average number of shares. Relative to the actual-share EPS, the average-share EPS will either inflate or deflate the per share earnings. The informed investors, who can substitute actual number of shares for the theoretical construct, are hence bestowed by the accounting rule an information advantage over the average investors. Earnings response coefficient is significant with denominator of EPS substituted while the explanatory power of theoretical-denominator EPS abates when it is contemporary with the denominator substituted EPS. Financial analysts’ expertise in the provision of idiosyncratic information to the market has been compromised by the average-share EPS, which is reflected heretofore in proforma earnings forecasts errors. Proforma earnings use a numerator different from accounting rules and to further temper the denominator with the actual number of shares will make pro-forma EPS forecast unintelligible to users. The unintended consequence of inflating or deflating the per share earnings misleads average investors in their decision-making process. Analysts should not issue proforma earnings forecast while researchers should abstain from using theoretical-denominator EPS for sample firms with equity change as their policy prescriptions may further aggravate the problem. A simple remedy to change the accounting rule, SFAS No. 128 is eminently anticipated, if not warranted.

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