Accounting and the Stock Market

Let us review how the functions of accounting interface with shareholders of the firm. Shareholders' contributions to the firm, usually in cash or real assets, are identified and recorded in the accounting system before the firm issues stock. The entitlement of the shareholders is determined by accounting records in the form of real capital and, for the purposes of preparing financial statements, converted into units of money through the application of valuation rules. The contractual performance of shareholders does not have to be reported to other participating agents because shareholders' obligations to the firm are fulfilled as soon as they pay for their shares. To help increase the liquidity of markets for equity claims, the accounting system provides credible and verifiable facts about the past operations of the firm, with special emphasis on the shareholders' interests. Reliable information about the firm attracts prospective investors who might buy shares from the current shareholders willing to vacate their positions in the firm. Public disclosure eliminates information asymmetry between the current and potential shareholders.

The accounting system of a firm and its surrounding markets operate in a symbiotic relationship. How do they depend on and influence each other? This chapter explores this question.

The Limited Role for Valuation Rules

Shareholders are entitled to the residual real or physical capital of the firm. Valuation rules translate this entitlement into units of money, say dollars. All valuation rules are imperfect and vulnerable to manipulation. Fortunately, the choice of a valuation rule affects only one of the five functions of accounting. The data provided for the functioning of equity markets are based largely on valuation rules. The other four functions of accounting (measurement of inputs, determination of
entitlements, contract performance, and provision of the common knowledge base) are largely independent of the valuation rules chosen to prepare financial statements. Valuation rules play no role in measuring inputs of agents because these are measured in physical units, nor do they determine the entitlement of any agent except, partly, the top managers.

**The Role of Information Intermediaries**

The market for equity claims consists of three segments. In the primary market, authorized shares of stock are sold by the firm, usually to a syndicate of investment bankers for a negotiated price or on a best-efforts basis for a fixed fee. The sale of stock to smaller investors by the primary buyers in the secondary market occurs shortly after the primary sale. These buyers often trade the stock among themselves in tertiary markets via organized exchanges or in special computer networks, designed for dealers (e.g., NASDAQ) or for institutional investors (e.g., INSTINET). Most of the trading volume occurs in this tertiary market. However, the firm itself is directly involved only in the primary market transactions (except for dividend reinvestment plans and occasional treasury stock operations). Transactions in the secondary and tertiary markets change the list of shareholders of the firm, but do not affect the number of shares outstanding, or cash, or any other assets of the firm.

Although some stock may be sold directly by the firm to large investors, much of the demand for stock in the primary market is derived demand. Investment bankers are intermediaries who buy the stock with the intention of reselling it to other investors. As buyers, they negotiate with the issuer of securities about disclosures, financial statements, auditors, exchange listings, and so on. Then they sell the potential investors on the stock’s attractive prospects. Investment bankers’ profit margins, the difference between the two prices, are the compensation for creating an effective search and negotiating mechanism between a single informed seller and a large body of buyers.

Investment bankers may also have an incentive to collude with issuing firms and to sell stock to buyers at inflated prices. However, investors protect themselves by relying on the good reputation of the investment banker and the auditor. This investor behavior limits the profitability of such collusive strategies in an environment of repeated transactions.

It is not unusual for investment bankers to insist, at the time a firm attempts its first stock offering, that the firm engage a reputable firm of auditors to verify its financial statements and registration forms, even though any licensed CPA is legally qualified to do this job. This practice has been criticized by smaller audit firms because they lose their fast-growing, most successful clients to larger audit firms in this process. From the shareholders’ point of view, larger audit firms, with better-known reputations to protect, provide a more credible assurance of the client’s accounting and control. Further, the larger pool of wealth controlled by the
partners of such firms and their insurance carriers provides a more promising recourse if an audit report turns out to be false.

Questions About Accounting and the Stock Market

Let us use the following six questions to frame our discussion of the relationship between accounting and the stock market:

1. Is it possible to make money in the stock market by analyzing publicly available accounting data?
2. Is it possible to make money in the stock market by gaining access to accounting data before they become publicly available?
3. Does the choice of accounting principles or of methods of disclosure affect the behavior of the stock market?
4. Does the behavior of the stock market affect the accounting and control?
5. What changes would take place in the stock market in the absence of accounting?
6. What changes would take place in accounting in the absence of the stock market?

Money from Accounting Numbers

The stock market rewards the discovery and use of information. If the trading value of information is less than the cost of gathering and processing it, the information remains unutilized. All publicly available information cannot be utilized for generating private profits for trading any more than all gold can profitably be extracted from sea water or riverbeds.

Information that meets this test (private trading value exceeds the cost) will be driven by competition among analysts to be processed as early as possible, until the marginal cost of faster processing approaches its expected marginal private trading value. If competition in the market for processing information were perfect, each type of information would take only as long to be utilized for trading purposes as the time it takes to process it, without the cost of processing exceeding its trading value.

Trading to profit from information tends to eliminate the opportunities for making such profit. The amount of time or the number of transactions that it takes to eliminate opportunities for making a profit depend on the liquidity of the market. When the expected profit is greater than the cost of trading, opportunities persist only as long as the price moves sufficiently to make the gross profit equal to, or less than, the transaction cost. In a market with large transaction volume, it would take a larger trading volume, but only a short period of time, to dissipate such opportunities. In shallow markets, dissipation can occur with only a small volume, but possibly over a longer interval of time.
The characteristics of market response to information follow from its competitive nature and apply to information from accounting as well as other sources. It is difficult to find information that is publicly available and whose profit potential has escaped the attention of other investors and analysts. However, it is not impossible, because someone has to be the first to make each discovery, and the relationship between the stock market and economic data and events is not fully understood.

Looking for publicly available accounting data that will help make money in the market is like prospecting for gold: easily accessible stream beds have already been searched, and going further up into the hills requires commitment and effort with no assurance of success. There is enough gold hidden in that corporate balance sheet to support a few hardy prospectors. A large nugget may occasionally be found, but there simply isn’t enough to precipitate a gold rush.

Academic reports about discovery of accounting numbers that can serve as the basis of profitable trading strategies are like new treatments for cancer reported in the medical journals every month. Both are results of careful analysis of special cases, and have less than perfect reliability. Such academic findings have to be followed up by a study of their practical feasibility in a world of frictions and transactions costs. Not surprisingly, only a small number of such ideas are ever put into practice (say, by opening a mutual fund to exploit such information), and even fewer actually succeed when they are employed. Commitment of a substantial amount of time and money and the chance of failure usually separate a research finding reported in an academic journal and getting rich from this finding. Researchers tend to undercount the false alarms sounded in the past, and underestimate the amount of time it should take for research findings to enter into practice. Practitioners cannot take all research at face value until they try out new ideas with small amounts of money. Those few ideas for making money from accounting numbers that do survive this long process and get into practice undermine their own validity through the competitive process. Trading in markets can transfer money but cannot print it.

If market prices adjust instantaneously to publicly available information, allowing no opportunity to recover the costs of the effort and time spent gathering and processing it, such efforts would not persist. The hypotheses of instantaneous adjustment of price to new information lead paradoxically to the conclusion that such an adjustment cannot occur due to the absence of private incentives to gather information. This conclusion, in turn, provides private incentives for search.

There can be no economic equilibrium in the market for information if prices adjust instantaneously to information.1 Relatively small but finite adjustment periods eliminate the apparent paradox that arose out of the early empirical studies of the stock market, which failed to detect price reaction to various types of publicly available information at the time of announcement. These findings led to some overzealous conclusions about the market reflecting all available information at all times and about financial analysis being a waste of effort. As it turned out, early empirical studies were conducted using monthly return data, and the
price adjustments that took mere hours or days to complete were drowned out in
the noise of monthly returns. More recent studies, using daily and hourly data,
show consistent price reaction to various types of information at the time they first
become available. Volume studies support the hypothesis of small but finite ad-
justment periods.

**Money from Advance Access to Accounting Numbers**

What is meant by access to accounting data in advance of its availability to the
public? It could refer to data that, having been gathered or compiled through the
accounting system, are kept in the custody of managers for subsequent public re-
lease. During the interim, these data are used by managers for internal planning
and negotiation and execution of contracts with various agents. Their use for the
purpose of trading in the equity market is prohibited. Would it be possible to for-
mulate profitable trading strategies on the basis of such undisclosed data?

Given all the fuss about insider trading and disclosure laws, the answer must
surely be affirmative. There is some evidence from commodity futures markets,
for example. The U.S. Department of Commerce and the Department of Agricul-
ture gather survey data that are kept confidential until formally released. At the
time of release, these data have a measurable impact on the relevant markets.
There are documented cases of profits made from occasional leakage of these data
through the employees of these departments. However, it is difficult to gather data
to provide an empirical answer to this question in stock markets. One would have
to gather reliable data on when information is produced inside the firm. It is diffi-
cult to know for sure if managers use data for personal profit after it becomes
available to them, because such acts are illegal and would not be done openly.

Researchers have generally based their tests of the profitability of trading
strategies on the hypothetical assumption that accounting data become available
for portfolio selection a specified number of days, weeks, or months prior to public
release. The “information content” studies measure the contemporaneous correla-
tion between accounting numbers and changes in the stock price that occur during
the period from which the accounting data are taken. The hypothetical assump-
tion about the availability of such data rules out causal inferences about ac-
counting and the stock market. All that can be concluded is that accounting num-
bbers seem to contain some of the same kinds of information that determine the
value of stock in the market place. The assumption that this information reaches
the market through the accounting system must be avoided, however, because it is
difficult to measure the price changes associated with the identifiable public re-
lease of accounting data.

The Ball and Brown study, the earliest and the best known of this genre, does
not directly address the question of whether the knowledge of a firm’s income,
twelve months in advance, would help make a profit in the market. Nobody actu-
ally knows that number at the beginning of the fiscal year when the investment
portfolios of their study are selected. Interpretation of the performance of portfo-
lios formed on the basis of information that does not exist at the time of their for-
mation is highly ambiguous. Empirical evidence to support an answer cannot be provided until a study is conducted using actual, rather than hypothetical, advance access to accounting information.

**The Effect of Accounting Methods on the Stock Market**

The market value of a share of stock is derived from investor expectations of the level and uncertainty of future dividends (or, alternatively, cash flows or earnings). Expectations of individual traders are aggregated by the market mechanism. Market value depends on investors' own beliefs about future dividends, as well as their beliefs about the beliefs of other investors. Accounting can influence both types of beliefs.

At the simplest level, accounting generates a time series of financial reports that serve as an important input into future projections. These projections become the basis of valuation that investors attribute to the firm, and therefore their trading decisions. The past data constitute the foundation of beliefs and expectations about the future. When accounting changes the observed data, it affects the projections and the stock prices. The process of belief and expectation formation is, perhaps, the most poorly understood part of economics. Various attempts have been made (e.g., the rational expectations hypothesis) to place some reasonable bounds on the admissible expectation formation processes. But our understanding of the process remains poor. Since expectations are rarely observed directly in the field, attempts have been made to study expectations formation processes in economically rich laboratory settings. These studies reveal it to be far more complex and variable than the ad hoc assumptions (e.g., the mean of past observations) routinely made in a great deal of research. This lack of our understanding of expectations most likely accounts for the great deal of variability that exists in econometric studies of the stock market consequences of changes in accounting for depreciation, inventory, oil and gas properties, research and development outlays, and many others. The fundamental problem is that the econometrician can control only for observable conditions. Unobservable expectations, so crucial to the valuation process, may vary greatly and be left out of the research designs.

Second, future dividends depend on the current physical resources of a firm, its contracts, and how well they are managed to produce wealth. Individual investor beliefs about the future (dividends, cash flows, or earnings) depend on what they learn about current physical resources and contract management from accounting or other sources of information. Internal accounting and control preserves the physical resources of the firm by ensuring that agents receive no more than what they are entitled to from the firm's resource pool. This function of accounting, important to the market value of the firm's stock, has not received much attention from accounting researchers. It is buried in the details of procedures that are used to create and maintain accounting and records, and is obscured by the limelight that financial reporting attracts.
Third, preserving the resources of a firm is important but hardly sufficient to generate future dividends. Managers must be motivated to utilize resources in a manner consistent with the contracts of the firm. This motivation is provided through design of the compensation, promotion, and job termination environment. Changes in accounting systems often alter managerial incentives and induce behavior more or less consistent with the goals of investors and other agents. It has been shown that the issuance of FASB Statement No. 8 on foreign currency translation led to changes in the way managers handled foreign exchange transactions. Similar arguments have been made with respect to the Statement No. 2 requirement to expense research and development outlays.

Fourth, a firm’s contract set induces interdependency among agents. Managers’ compensation may depend on the stock price, and the stock price depends on managers’ actions. We can think of patterns of decision making by managers and stock valuation by investors that fit each other so well that neither side has a reason to deviate from the pattern. If their contract is changed, these patterns of decision making may have to change to another pair that is in mutual equilibrium. Each accounting system linking the firm to the stock market corresponds to an equilibrium set of investment/dividend decisions by the managers and to competitive prices determined by the investors. Altering the accounting system changes the stock price, not because the market is fooled by the alteration, but because the firm’s production-investment decisions under the new contract are different.

Finally, accounting systems also differ on how well they distinguish poor managers from better ones. When firms choose among alternative accounting systems, the better managers can self-select themselves into the group of firms using conservative accounting methods. By doing so, they can signal to shareholders the quality of their own abilities, something that cannot be matched by less-skilled managers. By narrowing the range of accounting practices firms can choose from, the standardization of accounting also reduces the opportunities for the better managers to stand out amidst the crowd of mediocrity.

Changes in accounting policies are especially troublesome. Even public disclosure of accounting policies cannot completely ensure that all investors know that everybody has learned about the change. Accounting changes can cause the market price to change by virtue of their effect on the common knowledge aspects of information, even when they have no effect on the private information of any participant in the market.

The Effect of the Stock Market on Accounting

Empirical evidence on the effect of the stock market on accounting has not been sought with the vigor that has been applied to seeking the influence accounting might have on the stock market. The first efforts to standardize accounting methods used by unregulated publicly held firms in the United States originated in the stock exchange regulations governing the reporting requirements for listed
firms. However, the attraction of brokerage commissions rendered the exchange officials’ devotion to enforce these regulations less than exemplary, especially for well-established firms.

(The) R.J. Reynolds Tobacco Company did not publish an annual report until 1947 (for the year 1946) which included a standard form income statement, a management review of the previous year, and the outlook for the coming year. Up until that time the company had merely sent its shareholders once a year a two-page document entitled “Financial Statement” which set forth only a condensed statement and balance sheet for the year in question: in retrospect, it is shocking to recall the primitive status of financial reporting in a period as recent as the 1940s. In fact, this particular company, which had long been listed on the Big Board, did not reveal its gross revenues in its income statement until 1937. Because this concession followed the 10-K requirement by a year or so, it would seem a reasonable conjecture that statutory compulsion was the lever that reluctantly induced the change of policy.8

Regulations are more effective in influencing the accounting of new applicants for listing on the New York Stock Exchange. It is not unusual to find smaller firms, when they go public for the first time, being persuaded by their investment bankers to change their accounting methods as well as their outside auditors.

Surveys of corporate managers consistently reveal stock market reaction as a major concern in making or not making accounting changes. For example, when Granof and Short asked managers why they did not adopt LIFO during years of inflation, one of the frequently given responses was the fear of negative stock market reaction to lower LIFO earnings.9 The significance of stock market response to accounting methods was widely discussed during the debate on accounting for the costs of exploration for oil and gas. How important the alleged stock market effect actually turned out to be in the final decisions made by lobbying firms, the SEC and the FASB remains clouded after many investigations.10

**Accounting Without the Stock Market**

The accounting of closely held commercial firms is different from that of publicly held firms. Few formal comparative studies of accounting systems of firms listed and unlisted on the stock market are available. It is feasible, though not easy, to conduct a comparative study of accounting in private and public firms of similar size and in similar industries, and draw conclusions about what accounting might be like in the absence of the stock market. We should not be surprised to find less detail in financial statements, less disclosure, comparatively smaller expenditures on external audit, and greater diversity in the accounting practices of such firms.

One could argue that matching for size and industry is insufficient. There must be other economic differences that could explain why one firm chooses to be publicly held and another is not. An event-study could be focused on firms that were taken private but maintained public debt. Going public or private and adopting an appropriate accounting system is a joint decision of the firm, and such a study may
reveal if the equilibrium combinations of organizational forms and accounting systems exhibit joint variations.

**The Stock Market Without Accounting**

The simple, and to many people the obvious, answer is that the stock market could not exist without accounting. Such people find it astounding that so many people spent a quarter-century answering the question: “Do financial reports have information content?” Perhaps the answer is not so obvious. What would the stock market be like without accounting? Let us look again at how accounting and control interact with existing and potential investors.

Accounting measures the input of investors. The records of an individual investor’s input are kept by the company registrar. This part of accounting and control also determines how the total entitlement of shareholders (in the form of cash, kind, or stock dividends) is distributed among individual investors. Without proper accounting and control, investors will have little faith that they will receive their share of the dividends declared by the directors and will refuse to buy the stock of such a firm. This aspect of accounting and control is necessary for the very existence of the stock market.

Because shareholders’ wealth is a residual, it is sensitive to any leakage of resources from the firm. Changes in accounting rules raise the possibility of weaker control over managers’ behavior. The weaker the internal controls, the higher is the risk borne by the firm’s shareholders and the greater is the cost of transactions of the stock. Similarly, weaker disclosure and a less reliable system of financial reporting increase the transaction cost, reduce liquidity, and thus hurt both existing and potential shareholders by reducing their return on investment in the firm.

Given the legal problems of trading stocks in firms without an accounting system, research on the relationship of accounting and the stock market has been centered on measuring market price changes correlated with small changes in accounting systems. Major accounting events could have an observable effect on the stock price. But the effect of most accounting changes is small, and it is unlikely to be detected in volatile stock markets buffeted by so many forces. Conducting studies of small, incremental changes in accounting amounts is testing the importance of bricks to a building by taking out one brick at a time. Predictably, most studies on the correlation between accounting and stock market events do not find that accounting changes affect stock prices, in spite of the traditional publication bias against negative results.

Designing a research project to observe a stock market without accounting systems is infeasible, but thought experiments and comparisons with other markets for various types of claims are possible. One might speculate that in the absence of accounting, stocks will become more like other gambling claims, such as tickets bought at the race course. But even race courses use at least a rudimentary system of accounting, auditing, and public reporting of the pedigree and historical performance data about the horses, jockeys, and owners. These data provide mutually observable variables to define and settle the bets on the race course. Likewise, it
is practically impossible to enforce a contract, "I bet five dollars on horse X," unless the correspondence between the label X and a specific four-legged beast is mutually agreed upon, and a mechanism exists to collect the five dollars and to resolve disputes on this matter.

Accounting and control provides mutually observable variables in terms of which the shareholders' (and many others') contract is defined and made enforceable. In the absence of such a system, diffuse ownership of equity claims is not only inefficient, but also impossible. Claims that in an efficient market the accounting function is essentially limited to providing information about market risk and to explaining abnormal, firm-specific returns miss the whole point of what accounting and control does in a firm.

Problems of Inference

The empirical measurement of the relationship between the stock market and accounting is rendered difficult by several problems of inference and data. These may be described as "the needle in a haystack," the "expectations," and the "self-selection" problems.

The Needle in a Haystack Problem

When the size of the accounting effect on stock price is small, it is difficult to detect in a noisy market. It is possible to estimate the chances of discovering an accounting effect of a specified size in the stock market. There is only a 50 percent chance that an accounting event with a stock price effect as large as 6 percent over twelve months can be successfully detected at a 5 percent level of significance."

There are few accounting events for which one could argue, on a priori grounds, that their effect on the market value is large enough to allow a reasonable chance of detection through analysis of stock prices. It is hardly surprising that the results of most such studies report no stock price effects. One cannot conclude that there is no needle in a haystack by examining the haystack from an airplane.

What can we do? Before collecting data, it is prudent to estimate the approximate size of the market value effect one intends to look for and the size of the sample necessary in order to have an acceptable chance of discovering such an effect, if it exists. Such back-of-the-envelope analysis can save much effort and disappointment later.

The Expectations Problem

Markets tend to anticipate future events to the extent that such information is available and to incorporate it into prices. This characteristic has been the major rationale for using market value as an input to the process of making accounting policy. However, this property also turns out to be a major obstacle in measuring the value consequences of accounting policy for the value of the shares. This is the
expectations problem. The consequences of the expectations problem are discussed first at the level of choices made by individual firms, and then at the social level of standard setting and rule making.

A classical firm is motivated to change its accounting methods if it sees an opportunity to increase its value to its owners. As the firm’s environment changes, the management may switch from accounting method A to accounting method B in order to increase its value by $x$ dollars. In a rational market where participants observe these environmental changes, the accounting changes will not come as a complete surprise. Even if the market does not know the identity of the specific firms that make the changes, it will be able to assess the probability that any given firm will make this accounting change in a given period. Let $\pi$ be the probability of change in accounting method. In a rational market, the expected gain from a change in accounting method from A to B (which is $x$) will be incorporated into the market value of the firm before the market has any information about the identity of specific firms that make the change. Upon announcement of the change, the full effect of the accounting change on market value, $x$, will be observed. However, the price change observed at the time of announcement will be only $x(1 - \pi)$, because $\pi \times x$ has already been incorporated into the price.

Note that the higher the probability of change, $\pi$, the smaller the observed fraction of the total market effect. However, there is a consolation prize. The high value also means that from a given universe of $N$ firms, a large expected sample size $\pi \times N$ will be available. Conversely, small sample sizes are associated with larger fractions of the total market value effect being observable at the time of announcement. The larger the collectible sample size, the smaller is the fraction of the total market value effect that can be observed at the time of announcement. The ability of a competitive market to anticipate the future thus makes the task of measuring market value effects more difficult.

This problem is often addressed by using a control sample of firms that do not make the change and examining the difference between the two samples. The control sample research design eliminates the expectations problem, but only at the cost of introducing a new one—self-selection. We return to the self-selection problem in the next section.

At the social level of standard setting and rule making, the ability of the market to anticipate the future creates an even more serious problem. Suppose that a standard-setting agency, the FASB, made the following announcement:

We propose that effective January 1, all firms should use accounting method $A$ instead of method $B$. We think such a change will increase the market value of the equity of firms. But just to be sure, we have commissioned a research study to assess the effect of the proposed change in market value. If this effect is found to be negative, we shall withdraw this proposal.

Suppose that the effect of such an accounting change on a firm’s cash flow is a negative number $x$. Consider what will happen in a rational market. Prices will
decline by \( x \), and the market will conclude that the FASB will withdraw the proposal. Thus, the decline in price does not occur, which in turn implies that the FASB will not withdraw the proposal. This implies that the market price will go down by \( x \), and so on. In a noiseless market, which acts rationally to anticipate the future, it is not clear what the equilibrium point of this process is. A careful consideration of the rational expectations in security markets complicates the interpretation of empirical results, and especially their use for making policy.\(^{14}\)

**The Self-Selection Problem**

In a true experiment, the researcher randomly assigns each subject or firm to a treatment. For example, to examine the effectiveness of a new drug for cholesterol control, a medical researcher may randomly assign patients to be treated by the new drug, an old drug, or a placebo. In a quasi-experiment, on the other hand, the researcher looks at the attributes of the subjects and classifies them. For example, the researcher may separate those heart disease patients who smoke from those who don’t. Patients in this case are not randomly assigned by the researcher to smoking–nonsmoking treatments; they self-select *themselves* into those samples. If the condition of the smoking patients is found to be worse, one cannot necessarily conclude that smoking is the cause. Such inference is easier in the case of a true experiment.

Self-selection is perhaps the most difficult problem facing those who try to measure the stock market effects of accounting decisions. The quasi-experimental designs of such research are based on the assumption that there are no systematic differences between the two samples that are relevant to the accounting event being tested. In other words, we assume that firms have been randomly assigned to the test and control samples. This assumption is hard to defend. If accounting decisions were made suddenly, unexpectedly, and for no systematic reason, we can reasonably talk about measuring their effects on the stock price. If they are known in advance, the stock market must discount them in advance. If there are economic variables that can explain these decisions, any stock market effects must be associated with these variables and not with the accounting decisions per se.

This argument significantly complicates the measurement of stock price effects of accounting events. Much stock market research is conducted within the economic paradigm—agents act rationally to enhance their welfare within the constraints of their environment, and accounting decisions are seen as part of such actions. All stock price effects can properly be attributed to exogenous variables and not to endogenous variables. If accounting choices are endogenous to the system, no stock price effects can logically be attributed to such actions. Following this argument, the inference drawn from a stock price study becomes a function of how the researcher chooses to define the boundaries of the economic system. To the extent these boundaries are drawn arbitrarily, the inference drawn about the cause of the effect on the stock price becomes arbitrary also.
Summary

Because of the residual claimant status of shareholders, the stock market is one of the more important factor markets that interact with accounting in publicly held firms. The financial reporting and public disclosure aspects of accounting are particularly important for shareholders. Financial reporting includes assurances on the proper functioning of internal controls, because the shareholders’ resource entitlement is in the form of physical capital and it is not easily verified by them directly. Many aspects of this intimate link between accounting and the stock market remain empirically undocumented because of our lack of knowledge of how investors form expectations to value firms, the low signal-to-noise ratio, the anticipatory nature of competitive markets, and the self-selection problem of quasi-experiments. As a practical matter, the most fruitful avenue for research is to understand how accounting data can be used for estimating the value of firms’ securities.

The role of the managerial market in accounting has already been discussed in Chapters 4 and 5. We now turn our attention to external auditing, one of the important factors that publicly held firms must acquire and pay for.

Notes


CHAPTER 7 Accounting and the Stock Market


Additional Reading


