Market efficiency and accounting research: a discussion of ‘capital market research in accounting’ by S.P. Kothari

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Abstract

Much of capital market research in accounting over the past 20 years has assumed that the price adjustment process to information is instantaneous and/or trivial. This assumption has had an enormous influence on the way we select research topics, design empirical tests, and interpret research findings. In this discussion, I argue that price discovery is a complex process, deserving of more attention. I highlight significant problems associated with a naïve view of market efficiency, and advocate a more general model involving noise traders. Finally, I discuss the implications of recent evidence against market efficiency for future research.

JEL classification: M4; G0; B2; D8

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1. Introduction

In his excellent review paper on capital market research, S.P. Kothari surveys a vast collection of work that spans 30+ years. This lucid chronology will no doubt find its place among the more influential review studies in the literature. Like all useful survey papers, his article offers sufficient structure for young researchers to become acquainted with the main themes in this literature. At the same time, the paper provides seasoned researchers with a useful reference source on a broad spectrum of market related topics in accounting. I readily recommend it to anyone interested in capital market related research in accounting.

In this article, I focus on what I regard as the watershed issue in the body of literature covered by Kothari (2001). Specifically, I offer some reflections on market efficiency and the role of accounting research in the price discovery process. Implicitly or explicitly, each capital market researcher must come to terms with this issue. The degree to which markets are efficient affects the demand for accounting research in investment decisions, regulatory standard-setting decisions, performance evaluation, and corporate disclosure decisions. One’s belief about market efficiency also dictates one’s research design. Perhaps more importantly, given the intended audience of this volume, one’s view about market efficiency will have a profound effect on one’s research agenda. In fact, I believe that what a researcher chooses to study in the capital market area is largely a function of her level of faith in the informational efficiency of these markets.

On this subject, S.P. and I clearly have some differences of opinion. Reading his review, one senses that S.P. finds aspects of the evidence against market efficiency disturbing. In contrast, I find them liberating. He speaks earnestly about potential sampling errors and econometric concerns. He also raises legitimate concerns about the formative nature of behavioral theories. I share these concerns, and would encourage readers to think carefully about them. At the same time, I hope readers will regard them primarily as opportunities. In fact, these unresolved issues are the very reason I believe capital market research is an exciting place to be at the moment.

As S.P. observes, the evidence against market efficiency is mounting. This evidence is changing both the research focus and the research design in the capital market area. The terms of engagement are being redefined, and future researchers need to consider the implications of this evidence as they chart a course of action. S.P. makes a number of good suggestions. My purpose is to augment his suggestions, and offer a somewhat different perspective on the market efficiency issue. In particular, I think the behavioral finance literature deserves a more spirited presentation.

My thesis is that a naïve view of market efficiency, in which price is assumed to equal fundamental value, is an inadequate conceptual starting point for
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