



What do we learn from two new accounting-based stock market anomalies? ☆

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Abstract

Hirshleifer et al. (J. Account. Econom. 38 (2004)) and Taffler, Lu and Kausar (J. Account. Econom. 38 (2004)) document large and statistically significant abnormal returns from trading on balance sheet data and audit opinions. However, the statistical tests ignore high transactions costs, especially for selling short, that would likely make the trading strategies unprofitable. The accounting anomalies literature is adding little to what we know about how and why markets operate more or less efficiently. I identify some research questions and opportunities, highlighting those with accounting and auditing implications.

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1. Introduction

Hirshleifer et al. (2004), hereafter HHTZ, and Taffler, Lu and Kausar (2004), hereafter TLK, document new stock market anomalies related to net operating assets (NOA) and going concern modified audit opinions. Using current research

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designs, the papers show that the new anomalies are distinct from those identified previously. Ignoring transactions costs, trading on these public data yields large abnormal stock returns: 15–30% in the first year alone. The papers contribute by extending the domain of accounting-related anomalies to balance sheet levels and audit opinions. While the conference papers focused on establishing the statistical significance of these anomalies, the published papers also try to improve our understanding of their underlying causes. Both HHTZ and TLK cite behavioral finance theories to explain their anomalous results.

Interpreting the same evidence more skeptically, I conclude that the trading strategies are unlikely to be very profitable because of high transactions costs, particularly for short positions. I argue that apparent market inefficiency could arise from poor market design, poor benchmark models, regulatory interference, test misspecification or other joint hypothesis violations. Hence, at a minimum, accounting researchers should aggressively explore alternatives to the behavioral finance explanations that are commonly cited for market anomalies.

Redefining market efficiency/inefficiency as a continuum rather than the current yes/no dichotomy could open up a large research agenda in both finance and accounting. For example, a continuous market efficiency measure would help contracting parties estimate better ex ante the cost–benefit tradeoffs of stock-based compensation or mark-to-market accounting. Continuous measures of market efficiency would also improve our ability to evaluate regulatory initiatives ex post. Other research opportunities include exploring the impact of market design on market efficiency, theoretical and empirical studies of market evolution, and better modeling of investors' decision problems.

In the next section, I broadly discuss stock market inefficiency and how well behavioral finance theories explain stock market anomalies. In Sections 3 and 4, I discuss the two papers individually. Section 5 outlines alternative research avenues for improving our understanding of market behavior, and Section 6 concludes.

2. What can we learn from stock return anomalies?

HHTZ and TLK conclude primarily that U.S. and U.K. stock markets are inefficient. Many researchers resist this inference, presumably because we associate market efficiency with general equilibrium welfare propositions. But evidence of stock market inefficiency is no longer surprising. Anomalous evidence emerged with early event study tests of the efficient markets hypothesis (e.g. Ball and Brown, 1968), and has not abated since.¹ Grossman and Stiglitz (1980) argued that markets cannot be fully informationally efficient, since otherwise arbitrageurs would not be

¹Livermore (1930) found positive stock returns on average around 38 stock dividend announcements during 1928–29, which he interpreted as consistent with market “irrationality.” After adjustment for market-wide changes in the PE ratio however, there seemed to be no systematic market reaction. This paper is likely the first to demonstrate that inferences regarding market rationality are sensitive to research controls for market movements and firm characteristics.

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