

Explaining Efficient Market Hypothesis (EMH) in value relevance studies for accounting strategies.

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Abstract

Capital markets expedite the selling and buying of securities, like bonds or debentures and shares. The markets perform two significant functions such as liquidity and security pricing. The efficiency of financial markets or the Efficient Market Hypothesis (EMH) states that the prices of assets traded reflect all the available information accurately and reveal the shared beliefs of all users or investors about the predictive prospect of the market. Value relevance studies can be considered to be related to market efficiency. EMH is regarded as the most significant theory underpinning areas of accounting research. Fama first developed EMH using Efficient Market Theory. The idea of an efficient market is more interested in prices at any given point in time as “fully reflecting” available information. Fama argued that ownership allocation from the company’s capital stock, which represents the basic role of the capital market, is perfectly achieved as long as the market is efficient; this is because the market can provide accurate signals of prices from resource allocations.

Keywords: Capital market, Value relevance, Accounting information, EMH, Accounting strategies.

Market Theories

Market theories provided the essential foundation for developing the security prices model for financial assets and strategies that can explain market behaviour [1]. In support of the EMH, [2] use three assumptions listed below:

Investors react to new information, causing the prices in the stock markets to rise suddenly. Consequently, information disclosed as a footnote in a financial statement will be incorporated into the share price, the same as in the main statement.

The share price of the stock exchange traded fully replicates all publicly accessible information; and

Abnormal returns to investors cannot be earned, i.e., investors can assume to get information from the published accounts in such manner that will increase the incentives accruing to the individual as against accruing to the other investors. For example, every investor can assume to earn returns on a security equal to the risk taken.

Significant backing has been received from scholars for EMH assumptions [2]. The hypothesis posits that share price reactions to new financial information does not have any economic significance.

Two hypotheses were developed by financial theorists on accounting measures in the stock market. The assumption of

the first hypothesis is that the market is naïve, while the second one assumes that the market is efficient. However, Gautier and Underdown opined that the market is naïve especially when it produces information content that is inexperienced in nature in its financial reporting. Additionally, the hypothesis also assumes that investors are naïve if they are unable to read a financial report or detect any irregularities in the financial reporting process. Therefore, the market generally will react naively to the information provided. This is because investors in the market are relatively not sophisticated enough to interpret and analyse accounting information; it assumes that they determine the behaviour and efficiency of the market from information contained in the reports [2].

Beaver defined market efficient as the “quality of stock prices” under two dimensions of information (for instance, with and without general access to information system to investors). Market efficiency clarifies the relationship between share prices and information in a capital market [1]. An efficient market is a market one in which a competitive demand exists for relevant information by investors. For example, investors have equal access to information without manipulating the capital market by generating risk-adjustment returns in security market that are abnormal in a consistent manner [3].

Vast areas of security market studies have contributed to the understanding of accounting numbers. Security markets,

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according to [4], have been found to be extremely efficient when it comes to reflecting accounting information about an individual stock market or stocks as a whole. Market security can be efficient with respect to some accounting information when stock price information is known to everyone.

Fama suggested three elements of information that depend on the nature of the classifications with regards to security prices: 1) a weak form test or a weak market, which considers information set as historical prices; 2) a semi-form test or a semi-strong market, that considers market prices efficiently adjust to publicly available information (for example, stock splits, annual earnings announcements, or new security issues); and 3) a strong form test or a strong market, which is basically on the monopolistic behaviour of investors or a group to information accessibility that can be relevant for formation of prices to be reviewed. The last category (the strong form test) can be an exact description of the economy and be regarded as the benchmark by which to examine deviations in market efficiency in accounting research [5].

The primary issue with regards to market efficiency theory is that no possibility exists for out-performing the market in the long-run [6]; performance depends on the adequate pricing of capital and risk [7]. Capital markets are not essentially efficient and are not partially efficient. Developed and efficient markets can improve on economic growth by increasing the efficiency of utilisation and allocation of savings in the economy [1], and the significant role of the capital market is the provision of possession from the economy's stock market [8]. However, different factors determine the degree of market efficiency, cost of information, quality of information, stock market cost and the degree of market completeness, with other factors related to market efficiency [9].

Market efficiency is a significant concern in stock market studies [10]. Transitional and emerging markets do not have well-developed capital markets, which mostly show market inefficiency. Nevertheless, the real understanding is whether value relevance of accounting numbers has any material effect on market efficiency. Most studies related to market efficiency have drawn upon the hypothesis that stock market value is efficient in a semi-strong form ignoring market efficiency. However, these studies on market efficiency do not have a significant theoretical basis because researchers could not address the important answers to the following two questions: 1) financial statement information that takes a close relationship with stock prices; and 2) the theoretical framework measuring value relevance [10,11]. Notwithstanding, other researchers have disputed this assertion by Dung as the procedure is not standardised for use in value relevance studies [12]. This warrants the use of EMH in value relevance studies because of the non-standardisation of procedures on the use of other standards [13].

Because EMH is a strong assumption, especially in a market with numerous imperfections (emerging markets), a combination of Ohlson's Model and Aboody et al.'s (2002) proposition offers a suitable theoretical foundation to measure the value relevance of financial information [10].

Different forms of market efficiency have been tested using various markets in the world with diverse results [1]. Value relevance studies as a capital market research, with the EMH providing a theoretical framework as well as the basis needed for the capital market research in accounting (Kothari, 2001).

The EMH, in testing value relevance of accounting information, plays an important role in the stock market, and the market generally, setting post-listing and listing requirements for firms seeking prices in capital markets. For instance, the Nigerian Security Exchange (NSE) post-listing requirements place more emphasis on the release of information in a timely manner. A lack of timely financial reporting could cause investors to lose hope in the Nigerian financial market as reliable information cannot be guaranteed (NSE). Listed firms are required to provide information to the public on the quality of their accounting information. Nevertheless, the EMH needs the use of "expected returns" that assumes security prices are properly placed [14-16].

Conclusion

A theory is needed that can specify the bond between the prices and expected returns of individual capital in question. However, based on this principle, when accounting information is important to investors, they will adjust their conduct and the response from the market will be enhanced through a change in stock prices. Therefore, in this case, information is important and relevant when changes in stock returns (or stock prices) are associated with accounting measures. Researchers have generally established the EMH to be one of the important theories in describing capital market prices and an important concept for actual market pricing. Several studies have reported the weak form of market efficiency in several country stock market.

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