Chapter 4

Multiple Choice

1. Which of the following research approaches emphasizes going from the specific to the general?
   a. Deductive
   b. Behavioral
   c. Inductive
   d. Pragmatic

Answer c

2. Which of the following research approaches is based on the concept of utility or usefulness?
   a. Deductive
   b. Behavioral
   c. Inductive
   d. Pragmatic

Answer d

3. Which of the following research approaches is attributed to DR Scott?
   a. Deductive
   b. Ethical
   c. Inductive
   d. Pragmatic

Answer b

4. Which of the following outcomes of providing accounting information is an attempt to identify individual securities that are mispriced by reviewing all available financial information?
   a. Agency theory
   b. Efficient markets
   c. Fundamental analysis
   d. Capital asset pricing model

Answer c

5. Which of the following outcomes of providing accounting information is an attempt to deal with both risks and returns?

   a. Agency theory
   b. Efficient markets
   c. Fundamental analysis
   d. Capital asset pricing model

Answer d

6. Which of the following outcomes of providing accounting information is based on the supply and demand model
   a. Agency theory
   b. Efficient markets
   c. Fundamental analysis
   d. Capital asset pricing model

Answer b

7. The efficient market hypothesis holds that that financial markets price assets at their intrinsic worth, given all available information. Which of the following forms of the efficient market hypothesis defines all available information as knowledge of past security prices?
   a. Weak
   b. Semi-weak
   c. Semi-strong
   d. Strong

Answer a

8. The efficient market hypothesis holds that that financial markets price assets at their intrinsic worth, given all available information. Which of the following forms of the efficient market hypothesis defines all available information as all publicly available information including past stock prices?
   a. Weak
   b. Semi-weak
   c. Semi-strong
   d. Strong

Answer c

9. The efficient market hypothesis holds that that financial markets price assets at their intrinsic worth, given all available information. Which of the following forms of the efficient market hypothesis defines all available information as information, including security price trends, publicly available information, and insider information?
   a. Weak
   b. Semi-weak
   c. Semi-strong
   d. Strong

Answer d

10. Which of the following anomalies are related to particular time periods?
    a. Calendar anomalies
    b. Value anomalies
    c. Technical anomalies
    d. Other anomalies

Answer a

11. Which of the following anomalies are related to strategies designed to outperform the market?
    a. Calendar anomalies
    b. Value anomalies
    c. Technical anomalies
    d. Other anomalies

Answer b

12. Which of the following anomalies are related to investing techniques that attempt to forecast security prices by studying past prices and other related statistics?
    a. Calendar anomalies
    b. Value anomalies
    c. Technical anomalies
    d. Other anomalies

Answer c

13. What theory on the outcomes of providing accounting information attempts to answer the question: What is an individual's expected benefit from a particular course of action?
    a. Agency theory
    b. Efficient markets
    c. Fundamental analysis
    d. Capital asset pricing model

Answer a

14. Which of the following is not viewed as a cost to the principal in an agency relationship?
    a. Monitoring expenditures by the principal
    b. Monitoring expenditures by the agent
    c. Bonding expenditures by the agent
    d. The residual loss

Answer b

15. What theory on the outcomes of providing accounting information attempts to assess an individual's ability to use information?
    a. Agency theory

b. Efficient markets
c. Human information processing
d. Capital asset pricing model

Answer c

16. Which of the following is not a conclusion that has been drawn from human information processing research?
    a. An individual's perception of information is quite selective. That is, since individuals are capable of comprehending only a small part of their environment, their anticipation of what they expect to perceive about a particular situation will determine to a large extent what they do perceive.
    b. Since individuals make decisions on the basis of a small part of the total information available, they do not have the capacity to make optimal decisions
    c. Individuals are able to process and integrate large amounts of information simultaneously
    d. Since individuals are incapable of integrating a great deal of information, they process information in a sequential fashion.

Answer c

17. What theory on the outcomes of providing accounting information rejects the view that knowledge of accounting is grounded in objective principles
    a. Agency theory
    b. Critical perspective
    c. Fundamental analysis
    d. Capital asset pricing model

Answer b

Essay

1. Briefly describe the following research approaches:
    a. Deductive

    The deductive approach to the development of theory begins with the establishment of objectives. Once the objectives have been identified, certain key definitions and assumptions must be stated. The researcher must then develop a logical structure for accomplishing the objectives, based on the definitions and assumptions. This methodology is often described as "going from the general to the specific

    b. Inductive

    The inductive approach to research emphasizes making observations and drawing conclusions from those observations. Thus, this method is described as "going from the specific to the general" because the researcher generalizes about the universe on the basis of limited observations of specific situations.

c. Scientific method

The scientific method of inquiry, as the name suggests, was developed for the natural and physical sciences and not specifically for social sciences such as accounting. There are some clear limitations on the application of this research methodology to accounting; for example, the influence of people and the economic environment make it impossible to hold the variables constant. Nevertheless, an understanding of the scientific method can provide useful insights as to how research should be conducted.
Conducting research by the scientific method involves five major steps, which may also have several substeps:

i. Identify and state the problem to be studied.
ii. State the hypotheses to be tested.
iii. Collect the data that seem necessary for testing the hypotheses.
iv. Analyze and evaluate the data in relation to the hypotheses.
v. Draw a tentative conclusion.

2. What is fundamental analysis and what is its goal?

Fundamental analysis is an attempt to identify individual securities that are mispriced by reviewing all available financial information. These data are then used to estimate the amount and timing of future cash flows offered by investment opportunities and to incorporate the associated degree of risk to arrive at an expected share price for a security. This discounted share price is then compared to the current market price of the security, thereby allowing the investor to make buy–hold–sell decisions.

3. Describe the efficient market hypothesis and its three forms.

The efficient market hypothesis is an attempt to use the economic supply and demand model to determine (1) what information about a company is of value to investors and (2) does the form of the disclosure of various types of corporate information affect the understandability of that information?
This theory maintains that the price of a company's stock accurately reflects the company's value after incorporating the information available. As a result, knowledge of available information will not allow an investor to make excess returns. The three forms of the efficient market hypothesis (EMH) differ on the definition of available information.

According to the weak form of the EMH all available information is defined as knowledge of past stock prices.

Under the semistrong form of the EMH, all publicly available information including past stock prices is assumed to be important in determining security prices.

According to the strong form of the EMH, all information, including security price trends, publicly available information, and insider information, is impounded into security prices in such a way as to leave no opportunity for excess returns.

4. Define the following heuristics:

   a. *Mental accounting:*

      The majority of people perceive a dividend dollar differently from a capital gains dollar. Dividends are perceived as an addition to disposable income; capital gains usually are not.

   b. *Biased expectations:*

      People tend to be overconfident in their predictions of the future. If security analysts believe with 80 percent confidence that a certain stock will go up, they are right about 40 percent of the time. Between 1973 and 1990, earnings forecast errors have been anywhere between 25 percent and 65 percent of actual earnings.

   c. *Reference dependence:*

      Investment decisions seem to be affected by an investor's reference point. If a certain stock was once trading for $20, then dropped to $5 and finally recovered to $10, the investor's propensity to increase holdings of this stock depends on whether the previous purchase was made at $20 or at $5.

   d. *Representativeness heuristic:*

      In cognitive psychology this term means simply that people tend to judge Event A to be more probable than Event B when A appears more representative than B. In finance, the most common instance of the representativeness heuristic is that investors mistake good companies for good stocks. Good companies are well-known and in most cases fairly valued. Their stocks, therefore, might not have a significant upside potential.

5. Discuss the capital asset pricing model including the concepts of unsystematic risk, systematic risk and beta.

The capital asset pricing model (CAPM) is an attempt to deal with both risks and returns. The actual rate of return to an investor from buying a common stock and holding it for a period of time is calculated by adding the dividends to the increase (or decrease) in value of the security during the holding period and dividing this amount by the purchase price of the security or

$$\frac{\text{Dividends} + \text{increase (or} - \text{decrease) in value}}{\text{Purchase price}}$$

Since stock prices fluctuate in response to changes in investor expectations about the firm's future cash flows, common stocks are considered risky investments. In contrast, U.S. Treasury bills are not considered risky investments because the expected and stated rates of return are equal (assuming the T-bill is held to maturity). Risk is defined as the possibility that actual returns will deviate from expected returns, and the amount of potential fluctuation determines the degree of risk.

A basic assumption of the CAPM is that risky stocks can be combined into a portfolio that is less risky than any of the individual common stocks that make up that portfolio. This diversification attempts to match the common stocks of companies in such a manner that environmental forces causing a poor performance by one company will simultaneously cause a good performance by another, for example, purchasing the common stock of an oil company and an airline company. Although such negative relationships are rare in our society, diversification will reduce risk.

Some risk is peculiar to the common stock of a particular company. On the other hand, overall environmental forces cause fluctuations in the stock market that affect all stock prices.

These two types of risk are termed unsystematic risk and systematic risk. *Unsystematic risk* is that portion of risk peculiar to a company that can be diversified away. *Systematic risk* is the nondiversifiable portion that is related to overall movements in the stock market and is consequently unavoidable. Earlier in the chapter, we indicated that the EMH suggests that investors cannot discover undervalued or overvalued securities because the market consensus will quickly incorporate all available information into a firm's stock price. However, financial information about a firm can help determine the amount of systematic risk associated with a particular stock.

Since investors can eliminate the risk associated with acquiring a particular company's common stock by purchasing diversified portfolios, they are not compensated for bearing unsystematic risk. And since well-diversified investors are exposed only to systematic risk, investors using the CAPM as the basis for acquiring their portfolios will be subject only to systematic risk. Consequently, systematic risk is the only relevant and investors will be rewarded with higher expected returns for bearing market-related risk that will not be affected by company-specific risk.

The measure of the parallel relationship of a particular common stock with the overall trend in the stock market is termed beta (β). β may be viewed as a gauge of a particular stock's volatility to the total stock market.

A stock with a β of 1.00 has a perfect relationship to the performance of the overall market as measured by a market index such as the Dow-Jones Industrials or the Standard & Poor's 500-stock index. Stocks with a β of greater than 1.00 tend to rise and fall by a greater percentage than the market, whereas stocks with a β of less than 1.00 are less likely to rise and fall than the general market index over the selected period of analysis. Therefore, β can be viewed as a stock's sensitivity to market changes and as a measure of systematic risk

6. Discuss the difference between normative and positive accounting theory.

There are two basic types of theory: normative and positive. Normative theories are based on sets of goals that proponents maintain prescribe the way things should be. However, there is no set of goals that is universally accepted by accountants. As a consequence, normative accounting theories are usually acceptable only to those individuals who agree with the assumptions on which they are based. Nevertheless, most accounting theories are normative because they are based on certain objectives of financial reporting.

Positive theories attempt to explain observed phenomena. They describe what is without indicating how things should be. The extreme diversity of accounting practices and application has made development of a comprehensive description of accounting difficult. Concurrently, to become a theory, description must have explanatory value. For example, not only must the use of historical cost be observed, but under positive theory that use must also be explained. Positive accounting theory has arisen because existing theory does not fully explain accounting practice.

7. What is the basic assumption of agency theory? Why is the relationship between shareholders and management an agency relationship?

   The basic assumption of agency theory is that individuals maximize their own expected utilities and are resourceful and innovative in doing so.

   An *agency* is defined as a consensual relationship between two parties, whereby one party (agent) agrees to act on behalf of the other party (principal). For example, the relationship between shareholders and managers of a corporation is an agency relationship, as is the relationship between managers and auditors and, to a greater or lesser degree, that between auditors and shareholders.

   An agency relationship exists between shareholders and managers because the owners don't have the training or expertise to manage the firm themselves, have other occupations, and are scattered around the country and the world. Consequently, the stockholders must employ someone to represent them. These employees are agents who are entrusted with making decisions in the shareholders' best interests. However, the shareholders cannot observe all of the actions and decisions made by the agents, so a threat exists that the agents will act to maximize their own wealth rather than that of the stockholders. This is the major agency theory issue—the challenge of ensuring that the manager/agent operates on behalf of the shareholders/principals and maximizes their wealth rather than his or her own.

8. What is the goal of human information processing studies? What are the genera findings of these studies and what is the implication for accounting?

   Studies attempting to assess an individual's ability to use information have been broadly classified under the title *human information processing* (HIP) research. The issue addressed by these studies is, how do individuals use available information?

   In general, HIP research has indicated that individuals have a very limited ability to process large amounts of information. This finding has three main consequences.

   a. An individual's perception of information is quite selective. That is, since individuals are capable of comprehending only a small part of their environment, their anticipation of what they expect to perceive about a particular situation will determine to a large extent what they do perceive.
   b. Since individuals make decisions on the basis of a small part of the total information available, they do not have the capacity to make optimal decisions.
   c. Since individuals are incapable of integrating a great deal of information, they process information in a sequential fashion.

   In summary, individuals use a selective, stepwise information processing system. This system has limited capacity, and uncertainty is frequently ignored.

These findings may have far-reaching disclosure implications for accountants. The current trend of the FASB and SEC is to require the disclosure of more and more information. But if the tentative conclusions of the HIP research are correct, these additional disclosures may have an effect opposite to what was intended. The goal of the FASB and SEC is to provide all relevant information so that individuals may make informed decisions about a company. However, the annual reports may already contain more information than can be adequately and efficiently processed by individuals.

9. Discuss the concept of critical perspectives research in accounting.

Critical perspective research rejects the view that knowledge of accounting is grounded in objective principles. Rather, researchers adopting this viewpoint share a belief in the indeterminacy of knowledge claims. Their indeterminacy view rejects the notion that knowledge is externally grounded and is revealed only through systems of rules that are superior to other ways of understanding phenomena. Critical perspective researchers attempt to interpret the history of accounting as a complex web of economic, political, and accidental co-occurrences.

They have also argued that accountants have been unduly influenced by one particular viewpoint in economics (utility-based, marginalist economics). The economic viewpoint holds that business organizations trade in markets that form part of a society's economy. Profit is the result of these activities and is indicative of the organization's efficiency in using society's scarce resources. In addition, critical perspective researchers maintain that accountants have also taken as given the current institutional framework of government, markets, prices, and organizational forms, with the result that accounting serves to aid certain interest groups in society to the detriment of other interest groups.

10. Discuss the relationship among research, education, and practice in accounting.

Research is necessary for effective theory development. In most professional disciplines, when research indicates that a preferable method has been found to handle a particular situation, the new method is taught to students, who then implement the method as they enter their profession. Simply stated, research results in education that influences practice.

The accounting profession has been criticized for not following this model. In fact, prior to the FASB's development of the conceptual framework, research and normative theory had little impact on accounting education. During this previous period, students were taught current accounting practice as the desired state of affairs, and theoretically preferred methods were rarely discussed in accounting classrooms. As a result, the use of historical cost accounting received little criticism from accounting educators since it was the accepted method of practice, even though it has little relevance to current decision making.