

CRITICAL REVIEW OF THE REVOLUTION IN CORPORATE FINANCE

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Abstract

This paper discusses market efficiency as described in *The Revolution in Corporate Finance 3rd edition*. Stock market efficiency has a way of accurately represents real values of stock. The stock market has a way of correcting itself when new information is reported. The answer to whether or not it pays to manipulate EPS. The real function of bond rating agencies is also described. Also, a short view on how investors view changes in corporate finance and trends that lead them to buy and sell stock in individual companies.

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Introduction

This paper will summarize ideas found in *The Revolution of Corporate Finance*. Topics include theories of stock market efficiency, including accomplishments and limitations. It will discuss whether it pays to manipulate EPS. Also, a discussion of the real function of bond rating agencies will be engaged in this paper. A short summary of how investors interpret changes in corporate financial policy is discussed. This research is a compilation and synthesis of documents from some of the United State's top experts in corporate finance. The goal of this paper is to better educate the readers about facts and theories of how corporate finance works in America as it pertains to market efficiency.

Theory of Stock Market Efficiency

According to Ray Ball of the University of Rochester, "The idea is that investors compete so fiercely in using public information that they bid away its value for earning additional returns (Stern & Chew, 1998)." This describes the theory of stock market efficiency in a nutshell. According to Ball, "...in an efficient market, the expected part of the earnings increase should already be reflected in the price, and investors should trade on the new information." In simple terms, the prices are what they are because it is what the market says they should be. Prices for investments tend to correct themselves over time, and also as new information is given.

Ray Ball goes on to say that, "Any predictable trends in prices over time would mean that knowledge of past returns (essentially costless to acquire) could be used to predict future returns (Stern & Chew, 1998, p.4)." This does not mean that the

information will be accurate, but can be used as a tool for investing. Market efficiency will make the needed corrections--as investors invest. This fact is supported by Ball, "And since revenue and cost are equated in competitive equilibrium, the implication of stock market efficiency is that if the cost of reproducing public information is zero, then so are the expected gains. Security prices should therefore adjust to information as soon as it becomes publicly available (Stern & Chew, 1998, p.5)."

Ray Ball (Stern & Chew, 1998) does suggest that there are limitations in the theory of efficient market. He says that they are divided into three categories: (1) the theory's failure to explain certain aspects of share price behavior; referred to in the literature as "anomalies"; (2) defects in efficiency as a model of markets; and (3) problems in test the efficiency model (p.7). These limitations should be considered when investing and when considering the way the market operates.

Ray Ball discusses anomalies of market efficiencies (Stern & Chew, 1998):

- Price Overreactions. There is evidence that the prices of individual stocks overact to information and then undergo "corrections." The resulting negative correlations in prices appear to create profit opportunities for "contrarians" trading strategies.
- Excess Volatility. Robert Shiller, among others has argued that the stock market in general overreacts to events because of investors' pursuit of fads and other herd-like behavior. In support of his argument, he presents evidence suggesting that the volatility of stock prices is much too large to be explained by the volatility of dividends.

- The failure of CAPM to explain returns. The capital asset pricing model, as mentioned, has provided the primary means for measuring investors' expected returns; indeed, it was the workhorse for calculating discount rates for an entire generation of practitioners as well as researchers. But evidence that high-beta stocks do not earn higher returns than low-beta stocks do not earn higher returns than low-beta stocks has led some to pronounce the horse dead.
- The explanatory power of non-CAPM factors. Stocks with (1) small capitalization, (2) low market-to-book ratios, (3) high-dividend yields, and (4) low P/E ratios tend to outperform their expected returns, thus providing justification for yield-titled, small-cap, and other popular investment strategies.
- Seasonal Patterns. Researchers have provided evidence of seasonal patterns of hourly, daily, monthly, and quarterly duration. Particularly puzzling is the "weekend effect:" the tendency of stock returns to be negative over the period from Friday's close to Monday's opening. Such "seasonals" could lend support to technical analysts' claims to outperform market averages.

Ball admits, "it is difficult to tell whether such anomalies should be attributed to defects in markets themselves, to flaws in market efficiency as a way of thinking about competitive markets or to problems with the research it self (Stern & Chew, 1998, p.8)." The theory of stock market efficiency is only a theory, not proved to be perfect, but very applicable when considering investing in the market.

Does It Pay To Manipulate EPS

Another expert of finance is Ross Watts from the University of Rochester. His article "Does it pay to manipulate EPS" gives more insight on investing (Stern & Chew, 1998). The answer to this question is simply--no, it does not. Basically, Watts contents that "evidence suggest that the stock market is not systematically misled by accounting changes (Stern & Chew, 1998, p. 22)." Watts suggest that instead the secret may be to maximize cash if you want to maximize share price.

Management bonus programs are often tied to reported earnings, so managers manipulate the accounting procedures. Accounting changes are often done to manipulate appearance of EPS, but in the long-run seem to not affect the bottom line. Watts recommends that because manipulating EPS through accounting does not pay, it would be better "to structure a management compensation scheme which focuses not on accounting earnings, but on the source of value: cash flow (Stern & Chew, 1998, p. 24)."

According to the material covering manipulation of EPS, evidence points to an answer of no; it does not pay to manipulate it. Accounting procedures can account be manipulated to show temporary changes, but cash flow must be increased in order to make any real positive substantial change.

The Real Function of Bond Rating Agencies

Another important aspect of market efficiency that needs to be considered by smart financial analysts is bonds. A look into the real function of bond rating agencies may give some insight on the bond market. L. Macdonald Wakeman, from the University of Rochester writes about bond rating agencies. Wakeman informs readers

that, "Concern about this concentration of market power has led academics, businessmen, and politicians to suggest that the bond rating industry be reformed, federally regulated, or even nationalized (Stern & Chew, 1998, p.25)." This is because bond rating services appear to have a great deal of influence on interest rates. It is argued whether or not this is true. If it is true, then it could be argued that by giving a poor rating to a bond then there will have to be a raise in something else--like costs, to compensate for the loss. Such an influence may affect the fragile market place balance. Regulations may assist in minimizing such affects.

Wakeman brings up the argument that bond raters, such as Moody's, do not give a very accurate picture of the bond because their methodology seems to be based on only one set of criteria—the company earnings report. Wakeman says:

Three distinct pieces of evidence suggest that the rating services respond to changes reflected in nothing more current than companies' published accounting reports. First, and most obviously, Moody's gives accounting-based explanation (e.g., changes in coverages and leverage ratios) for more than two-thirds of the bond rating changes not resulting from specific events such as mergers or new financing. Second, the monthly distribution of Moody's rating changes is not uniform; instead a significantly larger number of rating changes occur in the months of May and June, shortly after the publication of most companies' annual reports.

The third piece of evidence is provided by studies attempting to "explain" and thus predict ratings and rating changes. Such studies construct

models simulating the bond rating process which correctly classify up to 80% of the bonds in their samples using data derived only from published accounting statements (Stern & Chew, 1998, p.26).

If this is true, then investors would not be able to identify which bonds are really out performing the market and are the best deals. Wakeman suggests that, "current bond ratings do contain information about the relative risk of a company's securities (Stern & Chew, 1998, p.26-27)." This is helpful for investors on a certain level. Nonetheless, issuing companies still have their bonds rated for the purpose giving incentive to buyers to take action. "The use of Moody's or S & P's is thus a cost-effective strategy which increases the net proceeds of the debt issue to the issuing company (Stern & Chew, 1998, p.28)." Both bond rating agencies and bond issuing companies seem to benefit from bond rating. As far as investors are concerned—Wakeman seems to suggest that it may not be such a great resource to use as the sole means for choosing a particular bond over another (p.28). From a company perspective, Wakeman say, "Because the markets do not view bond rating changes as conveying timely information, no effort should be made to induce a rating service either to upgrade a bond or to refrain from downgrading a bond. The resources expended would be better devoted to improving the company's performance (Stern & Chew, 1998, p.28)."

How Investors Interpret Changes in Corporate Financial Policy

Another look at financial market efficiency comes from an article by Paul M. Healy of Massachusetts Institute of Technology and Krishna G. Palepu of Harvard University. Healy and Palepu discuss, "How investors interpret changes I corporate

financial policy (Stern & Chew, 1998)." This article by Healy and Palepu suggests that investors' actions are reflected by announcements by the companies issuing stocks. The net result of their actions cause the stocks prices to increase or decrease according to the news from the companies. A decrease in stock prices result from increasing of the supply of a company's shares. Dividend increases are favored more than capital gains. Stock splits tend to increase stock prices because the number of individual investors tends to increase (Stern & Chew, 1998, p.29).

It is interesting to note that announcements from issuing companies seem to have a dramatic effect on the price their stock. This is shown by a record of companies who showed relatively flat earnings until the year that they made announcements of first dividend payments. Thereafter, earnings increased and continued to grow at large rates for three years following (Stern & Chew, 1998, p.30). Some of the companies tracked even had relatively permanent sustained earnings throughout a fourth year. This is evidence that the stock market responds positively to announcements of dividend initiations. According to Healy and Palepu, "Furthermore, it turns out that the larger the yield of the initial dividend, the more positively is the immediate stock price reaction to a given company's announcement of a dividend initiation. And perhaps even more telling, the larger the market's positive reactions to the announcement, the larger are the future earnings increases actually realized by companies initiating the dividend (Stern & Chew, 1998, p.30)."

This same study by Healy and Palepu (Stern & Chew, 1998), analyzed whether equity offerings signaled future earnings declines. They analyzed post-offer levels of

other firms in their industries. They concluded that, "...analysts do not reduce their earnings forecasts after the announcement of equity issues." It is interesting to note that in this study, actual stock prices decreased in the two days surrounding an equity offer from an issuing company. It appears that such announcement leads investors to believe that there is a higher risk (Stern & Chew, 1998, p.32).

What about stock splits? How do investors view stock splits? Healy and Palepu (Stern & Chew, 1998) tell readers that stock splits are used to keep a "...firm's price within an optimal trading range (Stern & Chew, 1998, p.33)." The trend of a reaction to announcement of a stock-split is, "The average market-adjusted stock price increase in the two days surrounding the split announcement is 3.7 percent. Further, the stock price reaction to the split announcement is proportional to earnings increased in prior years (Stern & Chew, 1998, p.34)." It should be noted that higher stock prices will result from companies that have higher earnings growth within two years prior to the announcement of the stock split. It appears that investors view stock splits as signals that previous earnings will increase and be sustained (Stern & Chew, 1998, p.34).

Conclusion

In summary, it appears evident that stock market efficiency suggests that the prices offered for investment on the market are a direct reflection of true value according to news and financial history of the issuing company. It appears that stock markets are efficient. The theory of stock market efficiency does have its exceptions, but generally speaking prices correct themselves with new information over time.

The answer to whether it pays to manipulate EPS or not. Some managers manipulate earnings figures intentionally to acquire bonuses. Others do it to reduce taxes. Earnings Per Share does affect the way people perceive the success of a company and whether it would be a good investment or not. The bottom line about manipulating EPS is that it does not seem to have a long-term effect. Research suggests that changes in accounting practices will reflect a change on appearance of earnings. Maximizing cash is the best way to increase earnings per share. It can be argued, however, that manipulating earnings could prove beneficial to avoid political scrutiny and opposition. A lowered reported profit reduces taxes for reporting companies. Time can be better spent at looking for ways to actually increase cash flow and earning rather than manipulate earnings figures.

As far as bond rating agencies are concerned, they do have a purpose, but not as many people would think. Their reports do have an effect on the market. The numbers reflected in these ratings are rarely current. People do trust that bond rating agency reports can be trusted as a tool for making investment decisions. They seem to have an effect on the way people view the stability of each investment. It should be noted that bond reporting agency reports should not be used as the only tool for deciding whether or not a company should be invested in or not, as they are not proven to be completely reliable. Issuing companies trust bond rating companies as a resource for an equivalency of "advertising."

It should be noted that investors are do show a trend in decision making when interpreting changes in corporate financial policy. When companies announce payment

of cash dividends—value of the company's equity goes up. When announcements of issuing of more shares are made—market values of existing equity falls. When splits of stocks are announced—market value of the company's stock increases, as does the number of investors for the stock. Investors interpret stock splits as a permanent earnings increase. Announcements do have an enormous effect on market efficiency.

References

Stern, J. M. C., Jr., D. H. (1998). *The Revolution in Corporate Finance* (3rd edition ed.).Malden, MA: Blackwell Publishers Ltd.