Department of Accounting
College of Commerce
National Chengchi University

Ph.D. Qualifying Exam- Financial Accounting
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PART 2

1. (15%)

The accruals anomaly -- the negative relationship between accounting accruals and subsequent stock returns -- has been well documented in the academic and practitioner literatures for almost a decade. To the extent that this anomaly represents market inefficiency, one would expect sophisticated investors to learn about it and arbitrage the anomaly away. Lev and Nissim (2006, CAR) shows that the accruals anomaly still persists and, even more strikingly, its magnitude has not declined over time. Their explanation argues that the accruals anomaly is recognized and, indeed, exploited by certain active institutional investors, but the magnitude of this accruals-related trading is rather small. By and large, institutions shy away from extreme-accruals firms because their attributes, such as small size, low profitability, and high risk stand in stark contrast to those preferred by most institutions. Individual investors are also, by and large, unable to profit from trading on accruals information due to the high information and transaction costs associated with implementing a consistently profitable accruals strategy. Consequently, the accruals anomaly persists and will probably endure. According to the results of Grundy and McNichols's (1989, RFS) and Huang and Litzenberger (1988), what is your expectation on trading behavior and trading volume of various investors for accrual effect?

2. (20%)

The abstract of Choi, O'Hanlon, and Pope (2006, RAS) claim their study as flows:

> Prior research using the residual income valuation model and linear information models has generally found that estimates of firm value are negatively biased. We argue that this could result from the way in which accounting conservatism effects are reflected in such models. We build on the conservative accounting model of Feltham and Ohlson 1995 and the Dechow, Hutton, and Sloan 1999 (DHS) methodology to propose a valuation model that includes a conservatism-correction term, based on the properties of past realizations of residual income and "other information". "Other information" is measured using analyst-forecast-based predictions of residual income. We use data comparable to the DHS sample to compare the bias and inaccuracy of value estimates from our model and from models similar to those used by DHS and Myers 1999. Valuation biases are substantially less negative for our model, but valuation inaccuracy is not markedly reduced.

From the viewpoint of Ohlson (1995) and Feltham and Ohlson (1995), propose various issues including topics, hypothesis, and research design to apply Ohlson model.

3. (15%)

Wasley and Wu (2006, JAR) study a relatively recent change in voluntary disclosure practices by management, namely, the issuance of cash flow forecasts. They predict and find that management issues cash flow forecasts to signal good news in cash flow, to meet investor demand for cash flow information, and to precommit to a certain composition of earnings in terms of cash flow versus accruals, thus reducing the degree of freedom in earnings management. Their results also suggest that management discloses good news in cash flow to mitigate the negative impact of bad news in earnings, to lend credibility to good news in earnings, and to signal economic viability when the firm is young. Their finding that management cash flow forecasts primarily convey good news is in contrast to the generally negative nature of management *earnings* guidance and suggests that different incentives drive firms' disclosure of different financial information. Based on Dye and Sridhar's (1995, JAR) research, what are your comments and/or prediction for industry-wide disclosure?