

Importance of efficient market hypothesis essay sample

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The concept of efficient market hypothesis (EMH), which suggests that “ an efficient market impounds new information into prices quickly and without bias,” (Bowman, 1994, p2) is of prime importance to the accounting field for determining the managers’ performance and the effectiveness of having a fully disclosed financial statements.

With EMH, stakeholders can determine the effectiveness of the appointed management by observing the stock price. “ In major stock markets...a rational consensus will be reached as to the share prices which best reflect the prospects for future cash flows...” (Bowman, 1994, p2). With millions of traders as monitoring mechanism, management’s good or bad decisions will reflect on the share price instantly. Since the primary objective for managers is to maximize the company’s share price, board of directors can evaluate management’s performance through the movement of share price.

Furthermore, it makes more sense to have executives’ compensation tied to the share price.

In an efficient stock market, information disclosure is a key requirement. If the managements want the stock market to correctly value the company’s shares, they must ensure that they provide sufficient information in a timely manner allow the market to do so. As Malkiel suggests, “ when information arises, the news spreads very quickly and is incorporated into the prices of securities without delay.” (Malkiel, 2003, p3) Having a fully disclosed financial statement about the current and prospect situation of the company will provide a more accurate valuation of the company’s share because information speeds up the process of reverting price to the true fair value.

The concept of EMH is important to the accounting world because it provides a feedback measure to manager performance and displays the effectiveness of full disclosure on financial statements. Due to this underlying mechanism of unconscious adjustment to information in the market, a company's value is being appraised by the consensus rather than being attached with a fictional value.

References:

Bowman, Robert G.. Buchanan, John (1995). The Australian Journal of Management, 20, 2, December 1995.

Malkiel, Burton G. (2003). The Efficient Market Hypothesis and Its Critics. Princeton University CEPS Working Paper No. 91 April 2003