TABLE OF CONTENTS

1 INTRODUCTION 9

1.1 Portfolio theory and external accounting numbers of firms 9
1.2 Purpose and outline of the study 11

2 A REVIEW OF RISK-ORIENTED ACCOUNTING LITERATURE 16

2.1 Classifications of risk-oriented accounting studies 16
2.2 The accounting beta approach 21
2.2.1 Accounting index models 21
2.2.2 Accounting beta studies 23

3 THE EFFECT OF THE ACCRUAL DAMPENING ON THE ASSOCIATION OF ACCOUNTING BETAS WITH MARKET RISK 28

3.1 On the relation between cash-based and accrual-based accounting betas 28
3.2 Accounting betas and the total market risk 35

4 THE ACCOUNTING VARIABLES AND THE DATA SAMPLE 41

4.1 Cash-based and accrual-based accounting income variables 41
4.2 The data sample 48
4.3 Data adjustments 50
4.3.1 Treatment of outlier observations of the accounting variables 50
4.3.2 Adjustment of sudden shifts in the absolute variables (CSA and ASA) 53

5 METHODOLOGY 54

5.1 The measures of systematic risk 54
5.1.1 The accounting betas 54
5.1.1.1 Differences between the levels forms of cash-based and accrual-based accounting index models 54
5.1.1.2 Two alternative model specifications 58
5.1.1.3 The estimation procedure of the accounting betas 60
5.1.2 The market beta 67
5.2 The market-based correlation and prediction tests 69
5.2.1 Contemporaneous correlation tests 70
5.2.2 Interperiod correlation tests 71
5.2.3 Prediction tests 74

6 EMPIRICAL RESULTS 79

6.1 Accounting index model results 79
6.1.1 Descriptive statistics on the accounting index models 79
6.1.2 Contemporaneous and interperiod correlation between the different accounting betas 87
6.2 Market-based tests 91
6.2.1 Bayesian adjustment of the market and accounting betas 91
6.2.2 Contemporaneous correlation tests 92
6.2.3 Interperiod correlation tests 107
6.2.4 Prediction tests 115
6.2.4.1 Mean Square Error metric 115
6.2.4.2 Mean Error and Mean Absolute Error metrics 129
6.2.5 Summary and discussion on the market-based tests 134

7 SUMMARY AND CONCLUSIONS 143

REFERENCES 149

APPENDICES 156

LIST OF TABLES

Table 4-1 The accounting income variables 42

Table 4-2 The firm/variable-specific frequencies of adjusted outliers in the accounting data 52

Table 5-1 The accounting betas introduced in the market-based tests, their notation, and the models and index variables used in their estimation 66

Table 5-2 Contemporaneous correlation tests between the market and accounting betas 71

Table 5-3 The estimation periods of predicted and predictor variables in interperiod correlation and prediction tests 74

Table 6-1 Accounting index models: condensed descriptive statistics 80

Table 6-2 A pairwise comparison of the cash-based and accrual-based bayesian adjusted accounting betas 86

Table 6-3 Kendall's coefficient of concordance: the divergence in risk rankings by the different accounting betas 89

Table 6-4 Contemporaneous (single security) product-moment and rank correlations between the market and accounting betas 95

Table 6-5 Contemporaneous product-moment and rank correlations between the market and accounting betas. Two-security portfolios formed according to the accounting betas 101

Table 6-6 Contemporaneous product-moment and rank correlations between the market and accounting betas. Two-security portfolios formed according to the market beta estimated from period 1970-85 102

Table 6-7 Contemporaneous product-moment and rank correlations between the market and accounting betas. Two-security portfolios formed according to the market beta estimated from period 1983-85 103

Table 6-8 Contemporaneous product-moment and rank correlations between the market and accounting betas. Three-security portfolios formed according to the market beta estimated from period 1970-85 104

Table 6-9 Interperiod product-moment and rank correlations between the long-term market beta(s) and short and intermediate period accounting betas 107

Table 6-10 Interperiod product-moment and rank correlations between the short-term market betas and accounting betas from three different estimation periods 111

Table 6-11 Naive predictions using previous periods' market betas as predictors: interperiod correlation tests 114

Table 6-12 Prediction tests with Mincer-Zarnowitz MSE decomposition. Predicted variable: ß7085A (long-term market beta) 117

Table 6-13 Prediction tests with Mincer-Zarnowitz MSE decomposition. Predicted variable: ß7072 118

Table 6-14 Prediction tests with Mincer-Zarnowitz MSE decomposition. Predicted variable: ß8687 120

Table 6-15 Prediction tests with Mincer-Zarnowitz MSE decomposition. Predicted variable: ß8587 124

Table 6-16 Prediction tests with Mincer-Zarnowitz MSE decomposition. Predicted variable: ß8487 125

Table 6-17 Prediction tests with Mincer-Zarnowitz MSE decomposition. Predicted variable: ß8387 126

Table 6-18 Prediction tests: Mean Error (ME) and Mean Absolute Error (MAE) statistics. Predicted variable: ß8687 130

Table 6-19 Prediction tests: Mean Error (ME) and Mean Absolute Error (MAE) statistics. Predicted variable: ß8387 130

Table 6-18a The Wilcoxon signed-ranks test of equality of medians of the accounting betas and the market beta (ß8687) 133

Table 6-20 Condensed summary on the market-based results 136

Table 6-21 Kendall's coefficient of concordance (W): the divergence in risk rankings by different bayesian adjusted accounting betas (within the same accounting system) and the market beta of period 1970-85 137

LIST OF FIGURES

Figure 2-1 A simple classification of different risk prediction approaches 20

Figure 2-2 A classification of index model studies 21

Figure 5-1 A serial accounting filter model 55

Figure 5-2 The prediction-realization diagram 76

Please note that, when tables and equations are referred to in the text, the first digit of the reference number (i.e. the chapter indicator) will only be used when the table or equation in question is located in another chapter.

LIST OF APPENDICES

Appendix 2-1 A review of studies on instrumental prediction of risk 156

Appendix 2-2 A review of some important accounting beta studies 159

Appendix 4-1 The exact definitions of the accounting variables used in the study 164

Appendix 4-2 The sample selection procedure 166

Appendix 5-1 R^2-statistics on the trend regressions 173

Appendix 6-1 Statistical properties of the accounting index models 174

Appendix 6-2 Correlations between the different accounting betas 180

Appendix 6-3 Contemporaneous product-moment correlations between annual market betas (estimated from period 1970-85) and accounting betas 187

Appendix 6-4 Exploitation of prior period cross-sectional association of the accounting betas with the market beta in predicting future market risk 188

Appendix 6-5 Firm-specific statistics on the market model regressions. Estimation period: 1970-85 192