China Journal of Accounting Research 6 (2013) 233–245

Contents lists available at ScienceDirect

China Journal of Accounting Research

journal homepage: www.elsevier.com/locate/cjar

A fundamentalist perspective on accounting and implications for accounting research

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ARTICLE INFO

Article history:
Available online 11 October 2013

ABSTRACT

This paper presents a framework for addressing normative accounting issues for reporting to shareholders. The framework is an alternative to the emerging Conceptual Framework of the International Accounting Standards Board and the Financial Accounting Standards Board. The framework can be broadly characterized as a utilitarian approach to accounting standard setting. It has two main features. First, accounting is linked to valuation models under which shareholders use accounting information to values their stakes. Second, the desirable characteristics of accounting information are inferred from the demand of investors and analysts who use the information in practice. This stands in contrast to the "qualitative characteristics" in the Boards' Framework which are embraced largely on the basis of their aesthetic appeal. These features lead to a set of broad accounting principles that resolve "recognition" and "measurement" issues at the core of the Boards' Conceptual Framework and also the central issue of a balance sheet approach versus an income statement approach. The framework in the paper also frames the research questions for researchers interested in accounting policy.

1. Introduction

Accounting academics are involved in a variety of research, but one mission is paramount: to develop sound accounting principles. Accounting is so important to society, whether it be managerial accounting for a firm,

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http://dx.doi.org/10.1016/j.cjar.2013.08.002

government accounting to its citizens, or financial accounting for investors of capital. Researchers are sometimes advised to avoid normative statements on accounting policy, but to deny this mission would be akin to a medical school that has no interest in healing patients. This paper ventures into financial accounting which plays such a critical role in the functioning of capital markets and resource allocation. We provide some recommendations but, more importantly, we provide a framework for researchers to grapple with the issue of what is "good accounting."

The question of what is "good accounting" absorbs the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the US. They struggle with the complexity of writing accounting standards with real dedication, but find themselves continually rewriting past standards – on revenue recognition, leases, pensions, off-balance sheet vehicles, restructurings, to name a few – or withdrawing from proposals – on fair value accounting for mortgages, for example. Some of this comes from dealing with complexity and adapting to changing conditions, and some from working in a political environment. But at the heart of the problem is the lack of an agreed-upon framework to guide standard setting and provide the cohesion and consistency that avoids a scatter approach.

The two boards appear to share this concern and have embarked upon a fresh conceptual framework project. Their endeavor starts with objectives and concepts. They then specify recognition and measurement principles that follow from these notions. "Recognition" determines what goes into financial statements and "measurement" dictates how they are measured. The sequencing of ideas appears to go as follows:

Objectives of Accounting

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Concepts Governing Accounting

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Recognition and Measurement Principles

However, the project appears to be getting little traction.[1] Our guess is that the Boards' approach will not be successful, though we wish them well. The underlying concepts of "relevance," "neutrality," "faithful representation," and "comparability" that they propose are admirable and hardly ones to disagree with. But these concepts are too broad to cut through to a solution on a particular accounting issue and do not connect in any concrete way to what users look for in financial reports. In the Recognitions stage, they state definitions of assets and liabilities to which future accounting must conform. This promotes a legalistic approach that ties accounting to those definitions, rather than to the users' needs, while entrapping preparers in a cobweb of accounting minutiae over interpretation of definitions. Complexity becomes the dominating characteristic. Anchoring accounting to a Hicksian definition of income and a "balance sheet approach" (as tentatively proposed by the Boards) has little resonance with analysts.[2]

This paper takes a utilitarian approach: we examine accounting policy from the perspective of a user, specifically the fundamental analyst who uses financial statements to value firms. "Fundamental analysis" involves assessing firm value from an understanding of business fundamentals, but those fundamentals are often observed through accounting numbers like sales, profit margins, balance sheet debt, and so on. Indeed, fundamental analysis is sometimes viewed as the processing of accounting information. What accounting helps the fundamentalist and what accounting frustrates her? Is it fair value accounting? Historical cost accounting? Rather than appealing to accounting concepts such as a "balance sheet approach," or specifying "fair value" or "historical cost" as an (in)appropriate "measurement attribute," we ask: what does the fundamental investor need? In so doing, we take the view that financial statements are a product and thus the accounting problem is one of product design, tailored to the customer: what does the customer need?[3]

[1] The two Boards released an exposure draft for the first stage of the project in May, 2008, covering the objectives of financial reporting and qualitative characteristics to govern accounting standards. They completed this stage in September 2010 and have since published proposals on Elements and Recognition and the Reporting Entity Concept. Currently, the Boards are conducting discussions on Measurement. See www.ifrs.org and www.fasb.org on the Conceptual Framework pages.

[2] A more detailed commentary on the initial stages of the Conceptual Framework project is in "A Framework for Financial Accounting Standards: Issues and a Suggested Framework," *Accounting Horizons* 24 (September 2010), 471–485, by the American Accounting Association Financial Accounting Standards Committee (James Ohlson and Stephen Penman, principal authors).

[3] This product design perspective is outlined in Penman, S. "Eye on the Prize: Directions for Accounting Research," *China Accounting Review*, vol. 6, no. 4 (December 2008), 465–476.