This seminar covers on-going theoretical and empirical research on financial accounting, valuation, and financial statement analysis.

The seminar has three themes:

First, we have a product focus. Unlike a natural science like physics or chemistry, accounting research is not an endeavor to discover how the world works. Rather, it is a design problem, a matter of constructing products to serve customers. In our case, the customer is the investor.

We focus on three products in this seminar:

(1) valuation products,
(2) financial statement analysis products, and
(3) accounting itself as a product for financial reporting.

Think of the residual income model as a valuation product, the Altman Z-score for bankruptcy prediction as a financial statement analysis product, and fair value accounting as a financial reporting product. Think of the complete set of accounting standards of the FASB and the IASB as a product. Are these good products or are they deficient? Can we design alternative products based on our research?

Clearly the three issues are connected: How one carries out a valuation or financial statement analysis depends on the accounting involved, so issue (3) impinges issues (1) and (2). And issues (1) and (2) provide insights for issue (3): If the accounting is “bad,” it frustrates valuation and financial statement analysis, providing feedback for how accounting might be improved.

Second, the structural features of accounting—the framing architecture of the financial statements—are important for both research design and product design. These structural features are given by the set of accounting relations that tie the financial statements together. So, for example, the following are structural accounting relations:

Shareholders’ Equity\(_t\) = Assets\(_t\) – Liabilities\(_t\)

Shareholders’ Equity\(_t\) = Shareholders’ Equity\(_{t-1}\) + Comprehensive Income\(_t\) – Net Dividend\(_t\)

Free Cash Flow\(_t\) = Operating Income\(_t\) – Change in Net Operating Assets\(_t\)

Earnings is not just an isolated number, but one that comes from a set of structural equations that determine what the number is conveying. These are features that must be recognized (and exploited) in research design and in the product design that flows from the research. What are their properties and how are those properties exploited in developing valuation and financial statement analysis products?
Third, measurement must be put on the components of the structure. Should assets be measured at fair value? Should R&D be measured as an asset on the balance sheet? Accounting principles govern measurement, so the question is the appropriate accounting principles for valuation and financial statement analysis. Earnings is a number delivered via a set of structural accounting equations, but also under accounting principles that dictate its measurement Book rate-of-return is not “real” profitability but an accounting measure affected by accounting principles. How, then, does one interpret a book rate of return for valuation and financial statement analysis?

In sum, the aim of research is to answer the question: What is “good” accounting? To answer this question, we focus on two product areas: valuation and financial statement analysis.

Assessment

Enrolled students will be graded on oral presentations and class participation (25%), a take-home exam (25%), and a written research proposal (50%). Both the take-home exam and the research proposal are due January 23, 2018. The take-home exam must be done individually, without consultation with other students. The research proposal can be discussed with other students and with Penman. Unenrolled participants are welcome to join in oral presentations if time permits.

Readings

Published papers can be downloaded from Columbia Libraries E-Journals. Unpublished papers are available from ssrn (as indicated) or will be posted to Canvas. All the papers listed are necessary to grasp the material, though we will not get to all of them in class sessions. Follow the trail through the references to further material.

Preliminary Reading (and further reading during and after the seminar):

The first two papers highlight themes in the seminar:

Penman, S. Eye on the Prize: Directions for Accounting Research, China Accounting Review Vol. 6, No. 4 (December 2008), 465-476.


The following two books are for the classroom and practitioners. They indicate the extent to which research has entered the product arena to date:


*You should be familiar with some of the classics of the empirical financial accounting literature (others will be covered in the course):*


*You should have some familiarity with asset pricing (or acquire it during the semester):*


*You should look at the Foundations and Trends series of monographs that review research in particular areas and give you a sense of the state of the art. Here is the relevant material for our seminar:*


In the reading list below, papers indicated by an asterisk (*) are ones we will cover in class. The other papers are also required for your wider reading.
Session 1. Introduction

Outline of the Seminar

Background: Capital Markets Research


Identification


Session 2. Accounting and Valuation: Theory I

Finance Theory:


**Accounting Theory:**


**Session 3. Accounting and Valuation: Theory II**

**Finance Theory:**


**Accounting Theory:**


**Valuation Practice:**


**Session 4. Accounting Structure and Specification in Empirical Accounting Research**


Session 5. Accounting and Valuation: Empirical Analysis


Session 6. Financial Statement Analysis


Session 7. Asset Pricing and Accounting

Asset Pricing


Videos on factor investing:


Accounting and Asset Pricing


Session 8. Return Anomalies and Accounting


### Session 9. Book Rates of Return and Risk


### Session 10. Accounting and the Cost of Capital I


**Session 11. Accounting and the Cost of Capital II**


Penman, S. *Accounting for Value*, Chapters 8 and 9.


**Post Script: Papers Applying Research to Practical Fundamental Investing**

(Unpublished papers are on Canvas)


Macquarie Research, Quantamentals: Know Your Value. February 2016.


Ak, B. and X. Zhang. 2017. Relative Informativeness of Top Executives’ Trades in Financially Distressed Firms Compared to Financially Healthy Firms.

