**An Accounting Prototype**

*AP-1*

*VP-1*

*VP-2*

**Cash Accounting for Value**

**Accrual Accounting for Value**

The problem with DCF valuation is an accounting problem. Accrual account reports earnings rather than cash flows and this ameliorates the problems created by using cash accounting for value. Hence accrual accounting as two enhancing properties – 1) investments typically are not allowed to affect earnings (the value-added measure) because they are booked to the balance sheet and 2) cash flows from operations are modified by additional accruals and this brings the future forward in time.

Bring the future forward in time reduces our reliance on speculative forecasts of the long term. Accrual accounting even recognizes value when there are no cash flows.

*AP-2 –* Accrual accounting brings the future forward in time, anticipating future cash flows.

**Adding Speculation to Book Value**

Value is added to book value only if the expected rate-of-return on book value is greater than the required return.

*VP-3*

**Anchoring on Earnings: The P/E Ratio**

**Accounting for Value**

Accounting supplies the anchor that investors seek to challenge speculation in market prices.

People oftentimes think they are using tools with precise inputs when in fact precision is severely lacking. Examples include assumptions about growth rates and discount rates. These inputs can be tweaked in many cases to arrive at answers that the user wishes to uncover as opposed to the arriving at the true answers.

**An Accounting Prototype**

A savings account is a simple instrument upon which we can test any valuation method. If it does not work for a savings account, it will not work for equities.

***The Savings Account***

Initial investment $100 this is it initial book value

Interest rate 5% also referred to as the rate of return on book value

Holding period indefinite a going concern

Distributions none a zero payout dividend policy

Earnings reinvested at the interest rate of 5%

Risk none interest rate will remain 5% into perpetuity

The required rate of return for the investment (or the discount rate) is the risk-free rate, which must be the certain earnings rate in the account.

**Glossary**

**Book value** is a key measure that investors use to gauge a **stock's** valuation. The **book value** of a company is the total **value** of the company's assets, minus the company's outstanding liabilities.

**Return on capital employed** (**ROCE**) is a financial ratio that measures a company's profitability and the efficiency with which its capital is used. In other words, the ratio measures how well a company is generating profits from its capital.