**An Accounting Prototype**

*AP-1*

*VP-1*

***VP-2*** If one forecasts that the rate-of-return on book value will be equal to the required rate-of-return, the asset must be worth its book value.

In equations 2.1 and 2.2, ***Value*** is equivalent to the market price. In the case of a risk-free investment, such as a risk-free savings account, the P/B equals 1. A P/B different than 1 has to do with uncertainty. A corollary to this notion is captured in Valuation Principle #2.

**Cash Accounting for Value**

Valuation models like the DCF can be highly speculative because they put too much weight on speculation rather than what we know. The DCF employs cash accounting and cash accounting leaves us with speculation because growth rate assumptions used in calculating continuing value is highly speculative.

A valuation that rides on estimated growth is a risky valuation. It is better to anchor a valuation on something we can observe now or can predict fairly confidently in the short-term. We want value justified by the facts. For that we need an alternative, less speculative accounting.

**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.

**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.