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**Accounting for Value**

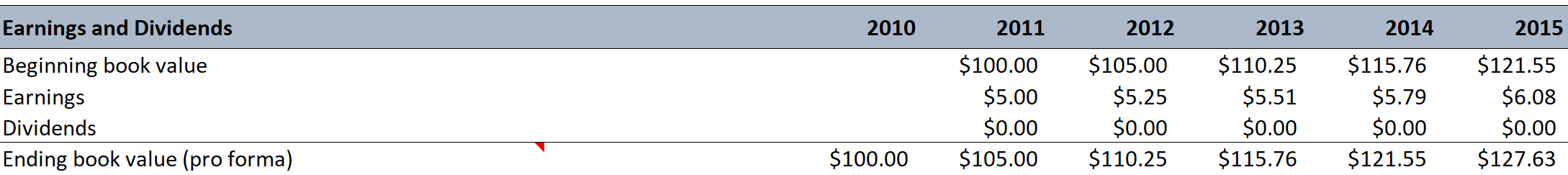
**Introduction**

***Appropriate*** accounting supplies the anchor that the investor seeks to challenge speculation in market prices. Analysts must avoid the trap of pretending they have precision, which they in fact lack. This is especially problematic in valuation. Valuation is inherently uncertain and assuming growth rates and applying CAPM to plug in discount rates exacerbates that uncertainty. We therefore must be honest in what we can do in handling uncertainty and what we cannot do. How do we circumvent these pitfalls?

**An Accounting Prototype**

The savings account is a simple instrument on which to test any valuation method. If the method does not work for a savings account, it will not work for equities.

*Figure 2.1 – Basic savings account*

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The savings account in Figure 2.1 has properties related to corporations that we are trying to value.

1. On-going concern – the account doesn’t have an expiration date,
2. the payout rate determines what proportion of earnings are paid out as dividends; in Figure 2.1 the payout rate is 0%, that is all earnings are retained and reinvested and earn a rate-of-return identical to the rate-of-return on book value,
3. the payout rate determines year-over-year growth rate in earnings and book value,
4. the accounting numbers for the future – 2011 and beyond – are pro forma numbers where earnings is the bottom-line number from the pro forma income statement and book value of equity derives from the pro forma balance sheet.

In Figure 2.1 the pro forma are certain (riskless). The required rate-of-return for the investment (discount rate) is the risk-free rate. In this situation, the rate-of-return on book value and the required rate-of-return are equivalent.

**Cash Accounting for Value**

**Accrual Accounting for Value**

**Adding Speculation to Book Value**

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

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**Stock Repurchases and Growth**

**Accounting for Growth from Leverage**

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***Hidden Reserves and Liquidation of Hidden Reserves***

***Starbucks Corporation: A Promise of Growth***

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***The Modernist Approach to Risk***

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**Growth Versus Value**

***E/P and Risk***

***B/P and Risk***

***Words, Words, Words***

**E/P, B/P, and Accounting for Growth**

**Returns to “Value” and “Growth” Investing**

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**Historical Cost Accounting and Fair Value Accounting**

**Fair Value Accounting as an Anchor**

**When Is Fair Value Accounting Appropriate? The One-to-One Principle**

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**A Lesson from Free Markets**

**The Misconception About Historical Cost Accounting**

***Microsoft Corporation***

***Dell Computer***

**Accounting for Value: A Balance Sheet Versus Income Statement Focus**

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**Returns to Penetrating the Accounting**

**What Is Good Accounting?**

**Caveat Emptor: What’s Wrong with GAAP?**

***The Balance Sheet***

***The Income Statement***

**Simplicity Is a Virtue, Complexity Is a Warning**