

Introduction

IT IS PROBABLY WITH mixed feelings that you find yourself holding a book on accounting in your hands. Apprehensive: Isn't accounting complex? Deflated: Isn't accounting boring? Amused: Remember all those accounting jokes? Your interest may occasionally be piqued when accounting is called into question, usually during a crisis—in the Enron collapse or the recent financial meltdown—but the discussions of revenue recognition, fair value accounting, variable interest entities, and so on that ensue quickly dissolve into technicalities beyond the common man. Or worse: Babel and confusion. Leave it to the nerds, it is not for me.

I hope to persuade you otherwise.

First understand that, while this book deals with accounting, it is primarily a book on valuation, written for investors and those to whom they trust their savings: investment advisors, analysts, and portfolio managers. The book explains how to employ accounting to estimate share value. It embraces the fundamental investing approach identified with Benjamin Graham, adapted to incorporate pertinent principles of modern finance. Fundamentalists distinguish price from value—the two can be different—and it is accounting, executed independently of price, to which the investor refers to determine the difference. This book shows how the investor handles accounting to identify value and challenge stock prices.

In this book the investor will see that accounting and valuation are so intertwined that valuation is actually a matter of accounting; valuation

involves performing an accounting on a firm, an accounting for value. Accordingly, a valuation is only as good as the accounting underlying it. There is thus a question for the accountant to answer: What is good accounting for valuation? Do generally accepted accounting principles (GAAP) fit the bill, or does the investor look for an alternative accounting for valuation? The book is a conversation with the investor about valuation, but a conversation that accountants—particularly accounting regulators and standard setters—are most welcome to sit in on. Like investment advisors, analysts, and portfolio managers, they also serve the investor. Just as poor valuation can harm an investor's savings, so can poor accounting. And there is considerable room for improvement in today's accounting.

The Importance of Accounting

If you have ever purchased a stock, you understand the importance of valuation, but let me persuade you of the importance of accounting.

In most endeavors, whether a household, a club, a firm, or a government, one needs to keep track. Indeed we account all the time as a matter of instinctive behavior. In personal relationships, one “keeps account” of the pros and cons—assets and liabilities, debits and credits—of the relationship, often instinctively. We do so in more formal arrangements, but more formally. With corporate accounting, owners keep track of their investments and the stewards who manage them, and with government accounting citizens keep track of their politicians. Without accounting to tell us where we are, where are we?

To function well, market economies require defined property rights enforced by independent courts, along with minimal restrictions on contracting. But of equal importance are accounting systems of high integrity that track our rights and obligations to each other. For our common wealth, accounting is critical for directing capital to firms that will use it most productively, and for the efficient functioning of capital markets where those firms are valued and where our savings are at stake. It is no wonder that in almost every crash—whether it be the 1929 crash, the recent financial crisis, or corporate debacles like the Penn Central failure in the 1960s or Enron more recently—the finger is pointed at the accounting (among other suspects). Accounting is boring when all is

well, but critical when one needs it most. Accounting can be complex—often unnecessarily so—but accounting is no joke. (But, still, let's keep those accounting jokes in inventory.)

Accounting defines reality. It does so by bringing specificity to what would otherwise be speculative generalities. Economists work with concepts of “revenue,” “cost,” “income,” “assets,” and such; concepts that are very helpful for economic reasoning but have no manifestation until someone puts a number on them. The rubber hits the road with measurement and measurement falls to the accountant. “Cost of production,” in reality, is an accounting measure and that reality is determined by how one does the accounting. “Economic profit” is a useful concept, but no one has seen it until a number is put on it; consultants market “economic profit” measures but their products are simply accounting measures with “economic profit” a mere label (and a pretentious one at that). Accounting gives expression to “profitability,” “financial position,” “growth,” and so on. Indeed, as we will see, accounting gives expression to “value.” Without accounting, these various concepts are simply in the mind of the beholder, open to speculation. Accounting forces concreteness, not just concrete numbers but also concrete thinking.

In the heyday of strong “efficient market” views, the accounting that fundament investors so rely on was dismissed: accounting does not matter, it was said, for the market can see through the accounting. What then, one might ask, does the market see? The standard answer is that the market sees through to the future cash flows. But one cannot, of course, see the future. The market must see something observable, something real, and that reality must be some form of information that forecasts future cash flows. We, of course, do see factories, employees, the movement of goods and delivery of services, but accounting produces a representation of these realities appropriate for valuation.

It is popular to dismiss accounting as unconnected to reality, an archaic system unrelated to cash flows. This is a gross misconception. One must always reserve criticism of any particular form of accounting—GAAP, indeed—but this is not the way to look at accounting as a matter of first order. Accounting forces managers to face the numbers in reporting to shareholders rather than deliver platitudes about plans and prospects. It forces them to come to grips with reality. Sound government accounting forces politicians to be straightforward in reporting

to taxpayers—to view borrowing as debt rather than revenue, for example. It forces reality. And sound accounting for valuation forces investors to come to terms with reality rather than speculate. That opens the question: What is sound accounting for the purpose at hand?

Accounting expresses our reality for another reason. You and I don't need a behavioral scientist to tell us that our ability to process information is limited, but behavioral research has told us that people adapt to this limitation by developing heuristics that focus on a few pieces of summary information. Investors do so when they multiply just one number, earnings, by a multiplier (the P/E ratio), to estimate the value of a share. Economists do so when they appeal to one economywide “earnings” number, gross domestic product (GDP), to summarize the performance of an economy. Both know they are taking shortcuts and glossing over the imperfections in the two numbers (the P/E heuristic is particularly suspect, as we will see). One should always be skeptical of any accounting measure, but the demand for summary numbers from the limited information processors of the planet is strong. They have straightforward questions, such as “What did I earn this year?” and “What did my firm earn?” They seek accounting summary numbers, like earnings, to treat as real numbers, to be relied upon. But again, the question is: What is a good summary number for the purpose at hand?

The cynic claims “There is more than one earnings number, it depends on how you measure it.” Possibly so, for measurement is difficult; perhaps we cannot hope for one number to capture all the texture of a firm's operations. But summary numbers we must have, a limited few that limited information processors can handle—perhaps sales, book value, and cash flow along with earnings. While applying a P/E ratio to one number, earnings, may be a bit too simple, reducing valuation to a form that deals with just a few numbers holds out the promise of reducing the scale of the equity valuation task to something akin to applying a simple formula in bond valuation. But this depends on how the accounting is done. Earnings should mean a lot, otherwise the accounting should indeed be dismissed.

Add to the cynics those who dismiss accounting with the claim that modern computing and the emerging XBRL technology for corporate financial data allow quick access to a huge array of information without summary financial reports. But computer information consists of many

millions of bits and the XBRL taxonomy is a huge array (which, in turn, typically aggregates millions of transactions). The user of these technologies—the valuation analyst, for example—is left with the task of handling the information and summarizing what it means. That process cannot be avoided and that process is accounting. Those with limited information processing ability might also take issue with the cynic’s advice: “Don’t worry about accounting, just disclosure; there is no issue if we just have full disclosure.” Disclosure is said to make things “transparent.” Transparency is a virtue, of course, but a core dump is not what they are looking for. Disclosure is a cop-out. We simply have too much data these days; data need to be assembled in a compact way. Lengthy disclosures are often supplied when the accounting is doubtful—when there are off-balance sheet entities permitted by the accounting rules or fair value “guesstimates” on the balance sheet, for example. Better accounting would be more transparent than disclosures that are often rendered as boilerplate.

Investors like accounting numbers for another reason. We understand that investing is risky and that risk cannot be eliminated. Modern finance has given us ways to measure risk and ways to reduce it—diversification and hedging, for example—but modern finance does not deal with a primary source of risk: the risk of paying too much for an investment. This, of course, is the concern of the fundamental investor, and that investor needs an accounting that supplies assurance in this regard, an accounting that helps to distinguish value from price. That brings us to valuation.

Accounting and Valuation

I trust that this apology for accounting is compelling, but persuasion comes from actually seeing accounting work in practice. This book focuses on getting the accounting to work for us in valuation. The book’s title, *Accounting for Value*, signals the orientation but we will see that something deeper is involved. Valuation itself is actually a matter of accounting. When one values a business one accounts for value. This is not just a turn of phrase; the choice of a valuation method is the choice of a particular accounting method and that choice determines the confidence one derives from the valuation. Indeed, we shall see that the

same principles underlie both accounting and valuation. One thinks about valuation in the same way as one thinks about accounting, and it is that thinking that is embraced to get insights about risk, growth, and value. With this practical focus, we are in a position to ask: What is good accounting? What is good valuation? What is good accounting for value?"

With valuation and accounting much the same thing, valuation is very much anchored to the accounting. The book thus harks back to the era of Benjamin Graham and his Defensive Investors (who merely protect against paying too much for a stock) and Active Investors (who exploit mispricing to their advantage). Both grounded their valuations in the fundamentals represented by the accounting. Those were the days before efficient markets theory displaced fundamental analysis as the prevailing paradigm. The view of "efficient markets" rationally pricing investment assets has come under significant challenge in recent years, not the least by investors who followed the advice that "the price is right," buying stocks passively, without investigation, and holding them "for the long run," only to be disappointed. Their experience during the bursting of the equities bubble of the late 1990s and the more recent financial crisis was sobering. They might well return to fundamental analysis and for that they need accounting numbers to anchor on, to protect them from the risk of paying too much. How does one account for value, to invest with some confidence?

The efficient markets view has come under challenge from academics as well. Not only have many market "anomalies" been documented that are seemingly inconsistent with rational pricing, but behavioral economists have also challenged the model of the "rational man," who is supposed to govern rational markets. Those of us on the planet with limited information processing abilities are capable of being moved by impulses—"animal spirits"—that result in irrational prices. We follow herds, we are moved by fashion, we are reluctant to realize losses, and we are hampered by overconfidence and a host of other psychological problems (that academics can recognize but we can't! The kids never learn!).

The field of behavioral finance is in its infancy, and many explanations for irrational markets are conjectural, but the behavioralists' idea of "bounded rationality" is appealing. Behavioralists are quick to say that the problem may not be so much with the "rational man" but

with the demands placed on the rational man by the “rational model” of man. The demands placed on our information processing abilities by the rational model flies in the face of considerable evidence suggesting that investors, individually and in aggregate, do not handle information well. To deliver efficient prices, modern investment theory requires investors to mentally visualize a myriad of covariances, risk factors, risk premiums, and expected returns, all of which vary randomly through time according to some “stochastic process.” Quite demanding; my head hurts. Sorry, I failed the rational man test. What is needed is an accounting for value that reduces the dimensionality of the problem.

We are indeed in conjecture land here, but might not the deviant traits that behavioral economists attribute to us be due to our failing to process information appropriately? Might market “irrationality” be a matter of failure to account for value? Accounting, governed by principles invariant to ourselves, supplies the rationality that escapes us, a counterweight to the limitations of our mental accounting with its tendency to speculate. Effective accounting supplies a check on our behavioral biases. It promotes the idea that one trades on a book—an accounting book—not on emotions, conjecture, or speculation. If the accounting is also invariant to prices, it serves to challenge prices affected by emotions, conjecture, and speculation. With this view, the idea that accounting is important to efficient capital markets becomes compelling, and the idea that “accounting does not matter” becomes objectionable. Accounting, appropriately executed, anchors investors and it anchors prices.

Accounting in the Present and the Future

To be clear, when talking of accounting, I do not necessarily refer to GAAP accounting or its recent variation in International Financial Reporting Standards (IFRS). GAAP and IFRS have some features that enhance valuation and some that frustrate it (as we will see). Rather, the focus is on the appropriate accounting for valuation, and that accounting may differ from GAAP. The Financial Accounting Standards Board (FASB) that regulates U.S. GAAP and the International Accounting Standards Board (IASB) that regulates IFRS are currently engaged in an extensive “Conceptual Framework” project to provide a

foundation to govern the accounting standards they issue. Where the two boards will end up is not clear at this point, but the project to date appears to be appealing to ambiguous accounting concepts like “recognition,” “measurement,” “balance-sheet focus,” and “exit value”—ideas far from the investor’s mind—rather than focusing on the issues that investors face. “Fair value accounting” sounds good—like ice cream and apple pie—while “historical cost accounting” sounds, well, dated. But does fair value accounting actually help me to value my shares, or does it frustrate me? Could it be that historical cost accounting gives me a better way of accounting for value? This book aims primarily to lay out an architecture for accounting for valuation, rather than a critique of GAAP and IFRS, but in doing so a critique is implicit. Indeed, Chapters 8 and 9 have some explicit complaints about U.S. GAAP and IFRS and where they appear to be headed.

In recent years, the quality of valuations by professionals has come into question, particularly during the bubble of the late 1990s. Analysts and investment advisors did not stay anchored to the fundamentals. But if the accounting is suspect, the anchor drifts. Important achievements have been made in developing GAAP (and now international accounting). The Securities and Exchange Commission (SEC) has expanded disclosure, despite the clutter of too many detailed regulations. But I fear that we are in losing our way. We are losing our sense of what is good accounting and what is bad accounting, and even the ability to sort it out. To be sure, many analysts are engaged in the diagnosis of “earnings quality,” the financial press is as vigilant as ever, and the SEC and similar agencies in other countries strive to enforce accounting rules. However, I am not thinking of the ability to detect violations of GAAP or IFRS, or to see through a firm’s attempts to arrange its affairs to be within the rules in form but not in substance, important though such efforts are. Rather, I am thinking of the ability to visualize and implement accounting that might be different from GAAP, accounting that serves its users. Commentators snipe at GAAP, at the details, but redemption is in the broader scheme of things.

Investors, analysts, accountants, politicians, accounting regulators and, yes, many accounting academics have lost the ability to think constructively about accounting design. Fifty years ago, partners at leading accounting firms wrote papers on a whole array of accounting issues

and held themselves out as thought leaders in accounting. Numbered among them are George O. May at Price Waterhouse and Leonard Spacek who led Arthur Andersen from 1947 to 1963. Accounting firms were populated by such thinkers, but now the thinking has been delegated to regulators and their bureaucracies, with accounting firms functioning as little more than compliance cops. It seems that Leonard Spacek's successors at Arthur Andersen had little idea of what good accounting and bad accounting for Enron would look like (or with too little conviction to stand up for it). To be fair, accounting firms are very sensitive to litigation and their job is to certify compliance with GAAP. Indeed, the fair value accounting that built the Enron house of cards was sanctioned by the SEC. The role of enforcing compliance is not to be underrated if we desire accounting with integrity but, in failing to tackle issues of accounting principle, accounting firms underrate themselves. A sense of professionalism has been lost. Universities that train the "professionals" once taught "accounting principles." Now they largely teach rules and regulations. A sense of inquiry has been lost in the classroom, and inquiry is what universities are supposed to be all about.

Did the SEC have a sense of good accounting when it approved fair value accounting for Enron? Does it today? Accounting regulators seem to be flailing around on many issues, without firm goalposts. Again to be fair, the FASB and IASB are subject to political influence—observe the directives from U.S. Congressional committees and the European Commission in the fair value accounting debate during the financial crisis—and politicians rightly have influence in democracies. But clarity in thinking should dominate, bringing persuasion to both regulators and politicians and a higher hurdle for lobbyists to surmount.

The folks at the FASB and IASB appear to be dedicated to the goal of forging a set of quality accounting standards. They do so not automatically, but with broad input from many sources. However, that input comes with the baggage of special interests, and deferring to a consensus of special interests is no way to develop a long-lived, robust accounting system. In launching their Conceptual Framework project, the FASB and IASB appear to be quite conscious that good accounting flows from good concepts, not consensus, but the direction they are taking is not promising. The ghost of Orwell rises. Regulators are proceeding to build one monolithic, worldwide set of accounting standards under the banner

of harmonization but a doubtful Conceptual Framework. If universities and colleges just teach the rules dictated by this regime, without challenge, a profession will have been lost and society will be the weaker for it.

How does one discriminate between good accounting and bad accounting? This can only be sorted out on the ground, at the point where accounting is employed. Just as a new drug is tested, with side effects noted, so must accounting be judged by how it helps or hinders its users. In this book I focus on equity valuation, and so will ask: When using accounting for valuation, what do we want the accounting to look like?

To the Reader

The book is pitched in the simplest terms your author can contrive. From Chapter 1 onward, the book has the ordinary investor “on Main Street” in mind, with the conviction that the financial system becomes more efficient when the investor whose money is at stake keeps an eye on the store. However, the “moms and pops” of investing have other things to do—being a mom or a pop is an absorbing task after all—so the book is probably of most relevance to the professional investor “on Wall Street” who manages the store for those on Main Street. The book presumes some familiarity with investing, though demands little accounting knowledge beyond an appreciation of what a balance sheet and income statement look like.

To those who manage the store, I trust that the book will help you to differentiate price from value—to help deal with the risk of paying too much for an investment—and so help you to be a worthy custodian of the people’s savings.

To those involved in accounting standard setting, I trust this book will be of some help at this important juncture as you rework your Conceptual Framework to guide the development of accounting standards in the future.

To accounting academics, I hope this book will help put us on a common platform as we apply ourselves to think about how accounting should proceed in the future.

To academics in finance, you may not appreciate the skepticism about efficient markets. But you will see how other principles of modern fi-

nance are relevant to fundamental investing and accounting. Modern finance and fundamental analysis have for too long been seen at odds. The first two chapters go to some length to establish accounting and valuation in a way that is consistent with the principles of modern finance. I hope you will see how the accounting lens on valuation yields solutions to problems encountered in asset pricing and equity valuation.

Most important, to the investor, I hope, first and foremost, that this book will help make you a more intelligent investor (to appropriate Benjamin Graham's term). But I also trust that the book will provide you with an appreciation of what good accounting looks like. The pressures on accounting should not be underestimated. Corporate managers, trade organizations, financial engineers, bankers, and politicians—even professional accountants—want accounting that serves their purposes, and are quite vocal in their demands. They do not necessarily have your interest at heart. Issues of power and hierarchy come to the fore when markets are organized by rules and regulations. At best, the confusion of voices leads to unfocused accounting standards. I hope that you will see in this book the type of accounting that is needed for intelligent investing, the type of accounting that provides you with some security as you engage in risky investing.

A Road Map to the Book

To remove you as far as possible from the feeling of grinding through a textbook, this book reads rather like a novel. It does not provide the excitement of a potboiler perhaps, but the plot develops and thickens (not impenetrably, one hopes) as the book proceeds, with a gradual resolution that shows how to “account for value” as a practical matter. Along the way, the conclusion to each chapter, after the first, summarizes the main takeaways at that point.

Here is the plot line (that still leaves some suspense for the reader). Chapter 1 lays out the investing principles under which fundamentalists of Graham's ilk operated and compares them with the principles of modern finance. In so doing, it provides a brief history of investment ideas of the last century. The chapter identifies those ideas that provide the foundation for fundamental valuation and for the design of accounting that supports it. Chapter 2 applies these principles to a valuation approach

based on accounting. It is here that one comes to understand “accounting for value.” Chapter 3 then goes active, taking the accounting to the task of challenging market prices. The fundamentalist is particularly concerned about paying too much for growth, so the focus is on understanding the growth expectations implicit in the market price and the value that the market is placing on growth. With that understating, Chapters 4 and 5 bring accounting into play to evaluate growth and protect the investor from paying too much for growth. Chapters 6 and 7 evaluate risk, particularly risky growth, and offer the active investor a method for determining the expected return from an investment that finesses the need to determine a “cost-of-capital.” The issue of “value” versus “growth” investing comes to the fore. Chapters 8 and 9 turn directly to the accounting, to ask how accounting might best be designed to aid valuation, engaging (among other things) the current debate over fair value accounting. Chapter 10 is a brief summary, pulling together the ideas of the book for the investor who wishes to be counted as one of Benjamin Graham’s “intelligent investors.”

Accounting for Value

