

Accounting

Accounting is important because:

- Most information about a company is published by accountants in annual reports and these are the inputs into our valuations.
- Taxes. Being mindful of taxes can save a lot of money.

The problem with accounting is its emphasis on historical certainty and accrual smoothing.

Market values are more relevant than historical cost, and accrual smoothing ignores the time value of money.

Opportunity costs, sunk costs and side-costs and benefits are also very important but difficult to quantify.

Cash Flows and Timing

In finance, the timing of cash flows is critical. For example, \$100 now is better than \$100 in one year when interest rates are 10% pa. \$100 now would turn into \$110 in one year.

In accounting, income measures such as Net Income (NI) and Earnings Before Interest and Tax (EBIT) are smoothed using accrual accounts including depreciation, amortization, provision for doubtful debts and others. This messes up the timing!

When valuing businesses based on balance sheet and income statement data, we must undo accountants' accruals to get back to cash flows which can then be present-valued.

Example: Cash Flows and Timing

Question: You contract a builder to construct a building. The builder and his accountant will accept a payment of:

- \$1m now; or
- \$0.1m at the end of each year for 10 years.

The builder doesn't care when you pay, either option is fine.

You can borrow and lend to and from the bank at **10%** pa.

The accountant says 10 annual payments of \$0.1m is equivalent to \$1m now, since that's how straight line depreciation expense works.

You have \$1m of cash in the bank now. When would you choose to pay the builder?

Answer: We should keep the original \$1m in our bank account and pay the builder \$0.1m every year for 10 years.

This could actually be done by just paying him the \$0.1m interest payments from the \$1m in the bank. Then at the end of 10 years we could keep the \$1m for ourselves!

Clearly, this is better than paying him the whole \$1m now and having nothing left.

Timing is important.

Accrual thinking is bad, unless interest rates are zero.