Penman, Stephen – Accounting for Value

Columbia University Press, 2011, [Equity Investing] Grade ★★★★★

I read this book a year ago and have thought about it since then. It felt like I had missed something important and that I needed to re-read it. I'm happy I did. The Business Professors at Columbia University have done it again. Accounting for Value is another truly interesting valuation book from the center of valuation excellence. But the underlying topic of the book is a bit surprising to an initial doubter. Accounting?

Accounting for value, the Penman way, is far more value added than it sounds. I will still use the Greenwald approach as my base valuation technique. But I have to agree with Penman that most valuation approaches are built on lots of guesstimates. That goes for the Greenwald approach as well, even though there are less of them compared to DCF techniques like Copeland's. The main advantage with Penman's approach is that it separates what we "know" from accounting from speculations about the future. I have started to use "Accounting for value" as a reality check to my "Greenwald Fair Values". For screeners, the Penman approach using accounting data for real valuation calculations is most probably better than simple key ratios like P/E, Price/Book etc.

Like Ben Graham, Penman's focus is to fight the animal spirits of Mr. Market by being careful of paying for more than accounting certainties. His starting base is the level and rate of change in book value of equity. Be really skeptical of paying for growth. Profitable growth is scarce. And never pay for returns created by leverage. Beware of using stock prices in determining fair values. Instead use Mr. Markets pricing to understand expectations. All of Penman's adjustments to true returns and growth are a delight to view.

In addition to the main part of the book - valuation theory based on accounting - there are two topics that are positive spillovers. Penman's review of the advantages (mainly) and disadvantages with cost accounting versus GAAP/IFRS raised my awareness of these issues immensely. We need to debate these issues much more. Mark to market value sounds so obviously right, but can we really trust and handle these sometimes subjective values in the next step from today's financial instruments to tomorrow's inventory or PPE?

The other topic is Penman's introductory discussion on valuation theory (often with recaps from Ben Graham's thinking), the EMH theory and behavioral finance. He blends these topics with a pure elegance seldom seen in a balanced conclusion where P (price) doesn't necessarily equal V (value). Even James Montier can get intellectual, objective arguments from Penman.

But I don't agree with Penman on two issues. Unlike Penman, I am very doubtful of the Fed Model and its explanatory power. And far more important, I don't fully understand how he decides when a company is genuinely value creating - when returns are above cost of capital (in EVA-terms). To me, this must be based on true values and not on accounting book values. Only then is g (the growth component) a factor to consider in the "valuation formula". I will buy the new edition of his "Financial Statement Analysis and Security Valuation" to find out.

This is one of few books on accounting that is an easy-read. The language is far better than most investing books (although to be honest, there are some repetitions of expressions). A year ago, I would have rated Accounting for Value a 2. Now it gets a 1. Today, I better appreciate Penman's strong argument for his method of prudent accounting valuation. And he also gets some bonus for the best attack - to my knowledge - on the inconsistent way most equity analysts calculate cost of capital (WACC).

Michael Persson, September 20, 2012