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Earnings vs Cash Flows: The Valuation Perspective

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Abstract : The research paper is an effort to compare the earnings based and cash flow based methods of valuation of an enterprise. The theoretically equivalent methods based on either earnings such as Residual Earnings Model (REM), Abnormal Earnings Growth Model (AEGM), Residual Operating Income Method (ReOIM), Abnormal Operating Income Growth Model (AOIGM) and its extensions multipliers such as price/earnings ratio, price/book value ratio; or cash flow based models such as Dividend Valuation Method (DVM) and Free Cash Flow Method (FCFM) all provide different estimates of valuation of the Indian giant corporate Reliance India Limited (RIL). An ex-post analysis of published accounting and financial data for four financial years from 2008-09 to 2011-12 has been conducted. A comparison of these valuation estimates with the actual market capitalization of the company shows that the complex accounting based model AOIGM provides closest forecasts. These different estimates may be derived due to inconsistencies in discount rate, growth rates and the other forecasted variables. Although inputs for earnings based models may be available to the investor and analysts through published statements, precise estimation of free cash flows may be better undertaken by the internal management. The estimation of value from more stable parameters as residual operating income and RNOA could be considered superior to the valuations from more volatile return on equity.

Keywords : earnings, cash flows, valuation, Residual Earnings Model (REM)
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