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Residual Earnings Valuation With Risk and Stochastic Interest Rates

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This paper provides a general version of the accounting-based valuation model that equates the market value of a firm's equity to book value plus the present value of expected abnormal earnings. Prior theoretical work (e.g., Ohlson 1995; Feltham and Ohlson 1995, 1996) assumes investors are risk neutral and interest rates are nonstochastic and flat. Our more general analysis rests on only two assumptions: no arbitrage in financial markets and clean surplus accounting. These assumptions imply a risk-adjusted formula for the present value of expected abnormal earnings. The risk adjustments consist of certainty-equivalent reductions of expected abnormal earnings. A key issue deals with the capital charge component of abnormal earnings. It is measured by applying the (uncertain) riskless spot interest rate to start-of-period book value. Risks do not affect the rate used in the capital charge, and accounting policies do not affect the formula's constructs. An application of the general formula shows how the classic risk-adjusted expected cash flows model derives as a special case.

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