Earnings, Cash Flows, and Ex Post Intrinsic Value of Equity 😾

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We reexamine the relative importance of earnings and operating cash flows in equity valuation. In contrast to previous studies that use stock returns (Dechow 1994) or future operating cash flows (Barth et al. 2001), we use *ex post* intrinsic value of equity as the criterion for comparison. We determine *ex post* intrinsic value of equity by discounting future dividends over a three-year horizon and market price at the end of the horizon by industry cost of equity. The advantage of the *ex post* intrinsic value measure over stock returns is that it is not contaminated by the stock market's fixation on reported earnings (Sloan 1996). Also, unlike finite horizon future operating cash flows, *ex post* intrinsic values better reflect the magnitude, timing, and uncertainty of investors' future cash flows (SFAC No. 1, FASB 1978). Our results suggest that accrualbased earnings dominate operating cash flows as a summary indicator of *ex post* intrinsic value.

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