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by Fischer Black

The Magic in Earnings: Economic Earnings versus Accounting Earnings

Users of financial statements—analysts, stockholders, creditors, managers, tax authorities and even economists—really want an earnings figure that measures value, not change in value. Analysts, for example, want an earnings number they can multiply by a standard price-earnings ratio to arrive at an estimate of the firm's value. Accordingly, the ideal set of accounting rules is one that makes the price-earnings ratio as constant as possible. The main thing lacking in present accounting practice is the recognition that this has been the goal all along.

Ideally, the earnings figure will take account of everything observable about the firm, including past earnings growth and past earnings volatility. Because everything that bears on the future will be incorporated in the current earnings figure, estimates of future cash flow, or future earnings, will be of no help in estimating the firm's value.

To be sure, the accountant's earnings figure will often yield variable price-earnings ratios. In arriving at his earnings figure, the accountant can use much information about the firm that analysts and the public will never know. But he cannot use information external to the firm, accounting rules that have not yet been agreed upon or even information about the firm that came in after the financial statement cutoff date.

The surprising thing is that, even though accountants have not formally recognized the goal of having an earnings figure that measures value, they have done a remarkably good job of achieving this goal. In particular, the variability of book value to price ratios exceeds the variability of earnings to price ratios, both across the universe of stocks and over time, suggesting that the earnings figure is a better measure of value than the book value figure. That's the magic in earnings.

WHO are the users of financial statements, and what do they want earnings to measure? The users of financial statements include financial analysts, stockholders, creditors, managers, tax authorities and even economists concerned with national income. (Earnings figures, somewhat modified, are used as the corporate component of national income.) I claim that all these users want the same kind of earnings figure. They all want earnings to be a measure of value, not a measure of change in value.

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