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The VIPs

The year was 1963. Beyond doubt the power couple of Hollywood then was Elizabeth Taylor and Richard Burton. While they were a couple, they made more than a half dozen films. After finishing "Cleopatra" they stopped in London to knock out a movie with very little of the spectacular settings required on location in Egypt and Rome. That movie was "The V.I.P.s" and the movie set was a reproduction of the VIP lounge at Heathrow Airport.

While the film earned a better than average reception of the couple's work, I had a problem with it. Burton played the role of a millionaire mogul. At one point a traveler, recognizing the famous business person, approached him and told him he had a company that he thought would be a great investment.

As proof, the traveler showed Burton the audited balance sheet. Burton said, "You're right – this looks really good." I let out a hoot in the quiet theater. My date poked me and said, "What's so funny?" We were in a theater in Ann Arbor and I was finishing up my final semester at the University of Michigan's business school to earn a master's degree in finance.

I was completing a course on investing and the semester's assignment was to analyze and then evaluate two companies and then pick one of the two as the preferred investment. The two companies assigned to me were Bulova Watch and Hamilton Watch (now long gone as companies). After doing as much spade work as possible I asked the professor for a little help and he sensed I was stuck on the major issue: the valuation of each company. Having completed a couple of semesters in Accounting, I thought the answer was obvious. There could be no way to choose between the two because each was fairly accounted for by their own book value.

The concept of Owner's Equity, or book value, originated in Italy early in the 13th century, or more than 800 years ago. The basic premise was that Assets equal Liabilities plus Owner's Equity. From that equation there arose the notion that changes on one side had to be matched by changes on the other. Thus, the practice of "double entry" accounting was born.

My accounting text was referred to as "Paton and Paton," both of whom, father and son, conveniently were or had been professors at Michigan. It was the standard accounting text at the time. Armed with the rigor and detail of their work, I approached my finance professor with my dilemma. It was clear he was looking for something other than simply reciting the book values of two watch companies. He asked, "How many stocks of companies trade always, and only, precisely at their book value?" Wanting to get a passing grade, I waited a bit before answering.

Indeed, some many, many years later I have co-authored an article in the current issue of the Journal of Investment Management. Its title is "What is Value in an Equity Market?" In that research we examine five different measures of value. Yes, price to book is one of them. But we also include price to earnings, price to dividends, price to sales and price to the replacement value of assets.

The Securities and Exchange Commission requires each public company to release independently audited quarterly and annual reports of their revenues, expenses, assets and liabilities. These reports must conform to what is known as GAAP accounting: Generally Accepted Accounting Principles. In total, companies spend billions on these audits. But, as my finance professor knew back in 1963, many other concepts than book value are at play in the open securities markets.

At first, one might wonder why if there are "Principles" or rules the SEC requires to be followed, how there can be other concepts affecting the price of a stock? The answer is that managements, even conforming to these rules, have been granted enormous discretion within those rules. And the reason for that discretion is that accounting is actually a language, akin to a computer program. It has rules and syntax. These are, therefore, general tools to be applied to the task of describing parts of a company. Given the diversity and change in companies, it should not be a surprise that there can be legitimate differences in how these tools are applied. It has been accepted that managements are in the best position to apply the rules. Yes, they must stay within the rules, but the range of possibilities is as wide as the diversity of companies.

When is a "sale" made? Is it when the sales person puts down the phone and yells "Yes!!?" Is the sale made when the invoice is collected? If the product sold is a complex one and is going to be delivered in portions, is the sale recognized in installments? The same questions arise for expenses. And assets like equipment take on value it seems when management judges business is good but are treated as scrap in "bad times."

All of these determinations are made within really broad guidelines by management. As a result, accounting provides very little of the certainty it seems to imply for many. Investors rightly should consider much more than the face value of the accounts.

Maybe Richard Burton saw more in that balance sheet than what the raw numbers revealed. Possibly that is why his character was a millionaire. But I thought that scene made it more of a humorous movie than a good investment.

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An asset's book value is equal to its carrying value on the balance sheet, and companies calculate it netting the asset against its accumulated depreciation. Book value is also the net asset value of a company calculated as total assets minus intangible assets (patents, goodwill) and liabilities.

The price-to-book ratio, or P/B ratio, is a financial ratio used to compare a company's current market price to its book value.