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Valuation and Risk Based on Accounting Measures

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Financial Accounting literature abounds with research and papers wherein accounting measures, specifically, earnings are used to estimate the value of a firm and hence equity. The argument is based on the premise that stock valuation should be based on financial information which in turn must be grounded in accounting disclosures. Given that accounting measures are generated internally and also audited, they are considered to be more objective, thus resulting in better stock valuation estimates.

With this background, the current paper extends the work of Penman (2010) to the Indian context. Based on data analysis the conjecture is that Residual Income Valuation (RIV) approach has the potential to estimate the value of stocks more accurately. As part of the analysis based on RIV, it was possible to identify overpriced and under priced portfolios and thus make arbitrage profit. However, the study is exploratory in nature and the conclusions cannot be generalized. For this purpose, a confirmatory study, that conducts the above process of analysis across different years and on greater number of stocks, needs to be conducted.

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