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On the empirical relationship between market value and residual income in the U.K.

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Abstract

This paper examines the empirical cross-sectional relationship between residual income and market value for U.K. firms. It does so because of recent claims that RI is a better measure for use by firms in internal planning and control activities than, say earnings. If such is the case then, presumably, we would expect that RI has a stronger association with market value than, for example, earnings. We conclude that the relationship between RI and market value is by no means perfect. Nonetheless, RI has a stronger association with market value, in conjunction with RD expenditures and opening and closing book value, than does earnings in conjunction with RD expenditures and closing book value. As a consequence, the capital charge element of RI does appear to add explanatory power to equations involving merely earnings, RD expenditures and closing book value. Our view, therefore, would be that the evidence presented in the paper

provides some support for advocates of the use of RI for planning and control.



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Keywords

research and development; residual income; corporate valuation; planning and control

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