Financial Analysts Journal ›

Volume 43, 1987 - Issue 2

Research Articles

Accounting Methods and P/E Ratios

Darryl Craig, Glenn Johnson & Maurice Joy

Pages 41-45 | Published online: 31 Dec 2018

Cite this article https://doi.org/10.2469/faj.v43.n2.41

by Darryl Craig, Glenn Johnson and Maurice Joy

Accounting Methods and P/E Ratios

If investors distinguish between companies' accounting methods in capitalizing earnings, then one would expect more conservative (i.e., income-decreasing) methods to be associated with higher price-earnings ratios. Using a sample of 117 firms over the 1970–75 period, the authors examined the relation between a company's P/E ratio and its method of accounting for inventory (LIFO versus FIFO), depreciation (accelerated or straight-line) and investment tax credit (deferred or flow-through); financial variables controlled for dividends, growth, beta and firm size.

The results indicate that dividend payout and firm size were the most important financial variables. Of the accounting variables, inventory method and investment tax credit method were significantly related to P/E ratio; companies that chose LIFO inventory and deferred investment tax credit had higher price-earnings ratios than companies that chose FIFO and flow-through tax credit. Depreciation method did not appear to be related to P/E.

PRICE-EARNINGS (P/E) RATIOS play a prominent role in investment analysis, and much attention has been given to exploring their determinants. This article investigates the relation between the accounting method a firm uses for reporting purposes and the firm's P/E ratio. In particular, we want to find out if a significant portion of the variability of P/E ratios is associated with differences in accounting methods.

The answer is important for several reasons. First, many reseachers believe P/E ratios are useful in selecting over and under-valued securities.[1] If P/E ratios are useful in stock selection, and if accounting methods are associated with P/E ratios, then P/E selection strategies presumably could be enhanced by knowledge of the accounting methods used. Second, if accounting methods are related to P/E ratios, then stock valuations based on P/E ratios should make allowances for differences in accounting.

Because earnings per share feed directly into the P/E ratio, it seems plausible that accounting methods should be related to P/E ratios. That is, investors would capitalize earnings in a way that fully reflects accounting differences between firms. If this is the case, then P/E ratios and accounting methods will be related, with more conservative (i.e., income-decreasing) accounting methods associated with higher P/E ratios. If the market does not distinguish between accounting methods, then they will not be related to P/E ratios.

Previous Research

In two early studies, O'Connell looked at the P/E ratios of electric utilities that normalized the tax benefits of accelerated depreciation and of electric utilities that flowed through the accelerated depreciation tax advantage.[2] Both studies, which together covered the period 1949 to 1966, found that normalizing companies had larger P/E ratios than flow-through companies, but neither study controlled for the effects of risk and growth.

Beaver and Dukes compared the P/E ratios of firms using accelerated depreciation with those of firms using straight-line depreciation for reporting.[3] Using a sample of 123 firms over the 1950–67 period, they found that average P/E ratios were larger for the accelerated depreciation firms.

1. Footnotes appear at end of article.

Darryl Craig is Associate Professor at the School of Business of the University of Wisconsin at Milwaukee. Glenn Johnson is Professor at the School of Business of Washington State University. Maurice Joy is Joyce C. Hall Distinguished Professor at The School of Business of The University of Kansas.

Purchase options *

Save for later

PDF download + Online access

- 48 hours access to article PDF & online version
- Article PDF can be downloaded
- Article PDF can be printed

EUR 48.00

Add to cart

Issue Purchase

- 30 days online access to complete issue
- Article PDFs can be downloaded
- Article PDFs can be printed

EUR 175.00

Add to cart

* Local tax will be added as applicable

Related Research

People also read

Recommended articles

Cited by
13