This study provides an explanation for the anomalous significantly negative price-earnings relation using the simple earnings capitalization model for firms that report losses. We hypothesize and find that including book value of equity in the valuation specification eliminates the negative relation. This suggests that the simple earnings capitalization model is misspecified and the negative coefficient on earnings for loss firms is a manifestation of that misspecification. Furthermore, we provide evidence on three competing explanations for the role that book value of equity plays in valuing loss firms. Specifically, we investigate whether the importance of book value in cross-sectional valuation models stems from its role as (1) a control for scale differences (Barth and Kallapur 1996), (2) a proxy for expected future normal earnings (Ohlson 1995; Penman 1992), or (3) a proxy for loss firms’ abandonment option (Berger et al. 1996; Barth et al. 1996; Burgstahler and Dichev 1997). Our results do not support the conjecture that the importance of book value in cross-sectional valuation stems primarily from its role as a control for scale differences. Rather, the results are consistent with book value serving as a value-relevant proxy for expected future normal earnings for loss firms in general, and as a proxy for abandonment option for loss firms most likely to cease operations and liquidate.

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Equity value is determined by “future earnings power,” it was said, but there was no explicit justification for using future earnings as a valuation attribute, nor was there explicit development of the forecasting of this earnings power. A considerable amount of accounting research in the years since Graham, Dodd and Cottle has been involved in discovering how financial statements inform about equity value. The amount of equity investment might depend on ROCE and the accounting for book values may affect ROCE. Under conservative accounting, for example, ROCE is below its no-growth rate if investments are growing, and reducing investments generates higher ROCE, as modeled in Beaver and Ryan (2000) and Zhang (2000). The model is used to examine the role of accounting earnings and book value in equity valuation and to explore cross-sectional differences in the behavior of the valuation function. Unlike prior studies (such as Ohlson 1995 and Feltham and Ohlson 1995) where capital investments are either unspecified or exogenously given, capital investment decisions in this model are made contingent on the firm’s operating profitability and growth opportunities. Valuation requires first forming beliefs about future capital investments, and then valuing cash flows to be generated from invested assets. It also rationalizes the “anomalous” association between stock prices and negative earnings found in empirical studies (which is due to regression model misspecification). The book value of a company’s stock is simply the stockholders’ equity per common share of stock, equal to the net asset value, equal to total assets minus intangible assets, such as goodwill, minus total liabilities minus equity related prior claims, including preferred stock and cumulative dividends in arrears, divided by the number of outstanding common shares. Treasury stock, which is the repurchase of outstanding stock by the company, is not include in outstanding shares. 