Earnings Per Share:

Further Comments

(a) as declared by the company; or
(b) as adjusted, for comparability with other companies, by the analyst himself.

A review of the accounting methods of determining company income is beyond the scope of this paper, but we cannot omit some reference to the nature and size of the problem. Every accounting statement contains a mixture of fact and judgment, and variations in judgment, or accounting policy, can materially affect reported profits.

Because of this we reject the idea that profits, as declared by the company, are an adequate basis for earnings per share calculations: they may vary too greatly for reasonable comparability, not only between different companies, but also within any one company from year to year.

Matters that typically require investigation and adjustment include: depreciation, extraordinary profits and losses, reserves, the treatment of subsidiary earnings and the accounting for stocks. The nature and extent of adjustment required is, in our view, best left to the analyst himself. As a starting point, however, we believe it is helpful to take account of the standard adjustments made by the Investment Service of The Stock Exchange of Melbourne.

Even adjustments of this kind leave room for inconsistency, in view, as the Investment Service itself says, "of the diversity and lack of uniformity in the published accounts on which they are based." To cite just one example, note the effect of the change, in 1961, in the depreciation policy of the

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The major problem areas seem to be:

1. The issue of bonus shares or, much less common in Australia, stock dividends.
2. The issue of new ordinary shares for cash.
3. The conversion of a senior security to ordinary shares (e.g., the conversion of convertible notes).
4. The replacement of a senior security (e.g., mortgage loan or debenture) by the sale of new ordinary shares.

In what follows we shall discuss each of these problems in turn, first citing what seems to us to be common Australian practice, and then noting alternative procedures and their merits and demerits.

1. Bonus Issues:

The issue of bonus shares is generally regarded in Australia for what it is—a mere accounting change. The number of shares has been increased but this increase has no real effect on the company’s earnings per share or on the shareholder’s share of them. In order to have a consistent series, the effect of the change, which reduces reported earnings per share, must therefore be eliminated by reducing all previously reported earnings per share. This is achieved by dividing previous net profit by the number of shares outstanding after the bonus. The same principle is applied in the index numbers used by Ian Potter & Co. Here, however, current earnings per share are adjusted upwards to form a series consistent with an earlier base year, in this case 1954 = 100.

2. New Cash Issues:

Much more controversial is the treatment of new share issues for cash. The solution adopted by Ian Potter & Co., and apparently used by most Australian analysts, is to adjust earnings per share by the bonus element in any issue made below market price. The bonus element in a cash issue is usually arrived at by assuming that sufficient rights to an issue are sold to finance the balance of the entitlement, this balance being regarded as bonus shares. The earnings per base-year share in each succeeding year are then arrived at by multiplying the actual earnings per share each year by the number of shares the original 100 has grown to at the time: the same procedure as for an ordinary bonus issue.

This approach has a definite shortcoming in that the influence of market prices becomes permanently incorporated in the results. Moreover, the assumption that an investor sells enough rights to his entitlement to finance the balance may, especially in the case of large institutional investors, be a very unreal one, and this further weakens the usefulness of the method.

One may take comfort in the work of Davies, who concludes that in practice the method is not nearly as sensitive to variations in market price as Harris suggests, and that as alternatives involve arbitrary choices on the part of the analyst, the standard method of adjustment is a sensible and practical second-best.

Although this may be so for the short-to-medium-term investor, for the long-term continuing investor the method is, we believe, of limited use. We suggest, therefore, a different method, based on the assumption that all rights to new issues are taken up. The essence of the method, illustrated in the following example, is the calculation of an earning rate on average cost of shares.

Example: It is assumed that 100 B.H.P. shares were purchased in May, 1954, and that all subsequent entitlements were taken up. (See Table 1.)
As a second alternative, we put forward for consideration the argument of an American analyst. Robbins contrasts two companies with different financial policies: one which retains substantial earnings and from time to time capitalises these by bonus issues; the other that pays out more in dividends and replenishes these funds by the cash sale of shares. Theoretically, he argues, both companies may be able to counterbalance, by greater earning potential, their enlarged capital. "Despite this similarity in effect, it is common practice to assume that the corporation selling stock for cash has more earning power, which may make it unnecessary (where the issue is at market price) to adjust previously reported per-share earnings. At the same time, as Robbins points out, it is also the practice to adjust prior data for the increased number of shares resulting from bonus issues or stock dividends.

Robbins finds it expedient to ignore this differentiation by reducing all previously published per-share earnings to a uniform base. Theoretically, a company raises its earning power through the use of funds derived from sale of new securities or conserved through distribution of stock dividends (or bonus issues), its reported net income will advance with corresponding increases in its per-share earnings. If it cannot increase its earning power, both the reported net income and the per-share data will show an unchanged trend.

Robbins' method has an attractive simplicity (some will say simple-mindedness!), and although it seems to avoid the problem of the proper distinction to be made between bonus issues, cash issues at market and cash issues below market, it could be that these matters have been over-emphasised in the literature of the subject. Robbins' method does at least stress what is probably the major factor: a company's ability to increase its earnings irrespective of the source of its funds for expansion.

We could go even further and suggest that in many cases a better measure of growth in earning power might be obtained by using earnings before depreciation and taxation rather than net profit. By using pre-tax earnings the temporary distortions of tax losses, special plant investment allowances and changes in tax rates are avoided, and by taking earnings gross of depreciation we eliminate an item of cost which can contain major elements of judgment.

Table II compares trends in "earnings per share", as previously defined above, for B.H.P. from 1954 to 1964.

3. Convertible Notes:

As recommended earlier in this paper, convertible notes may be treated as capital, and net profit adjusted to include interest on the notes, after allowing for tax. Note that interest on convertible notes is deductible for tax purposes only in the case of notes issued before November 1960.

4. Sale of Shares to Replace Long Term Debt:

Most Australian analysts seem to ignore this probably not very common change in capital structure. In the United States it is apparently

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1 Sidney M. Robbins, op. cit., p. 290.

(Continued Inside Back Cover)
INDUSTRY SURVEY TEAMS

Members will recall that Mr. H. V. Napier in his Presidential Address to the Society in September, 1964, suggested that the Society undertake a series of industry surveys in parallel with its regular company studies.

In its consideration of Mr. Napier’s detailed proposals the Executive Committee of the Society did not feel that present member resources allowed the setting up of survey teams to cover all industry groups. However, it did consider it highly desirable that an early start should be made with a broader-based approach to the problems of security analysis than studies of individual companies alone. Accordingly it decided to proceed with the setting up of survey teams for a few selected industries and to extend the coverage as resources permit.

Establishment of teams for the Hotel/Motel and Meat industries has been put in hand on the basis that teams will be staffed in groups of three. To provide for continuity of study without obligating members to serve on teams in perpetuity, it is proposed that team members will retire and be replaced at about six monthly intervals to achieve a complete turnover of each team on about an 18 months’ cycle.

Through the courtesy of Mr. Napier, the City Mutual have agreed to make available in their building a room in which industry information can be collated and stored for ready reference by Society members. It is also envisaged that regular study sessions of the Society would be arranged to appraise industry trends in the light of the information accumulated and to consider their implications for the securities of the main companies operating within the industry concerned.

The Executive Committee of the Society attaches considerable importance to getting these industry surveys established on a sound basis and hopes that members will lend enthusiastic support.

If you have a particular industry interest which you would like to see incorporated in the survey programme: OR if you would be interested in participating in one of the studies as a member of a survey team please complete the attached slip and return it promptly to the Honorary Secretary.

The Honorary Secretary,
Australian Society of Security Analysts,
Box 5085 G.P.O.,
SYDNEY, N.S.W.

Dear Sir,

I would be interested in participating in a survey of the.......... industry.

I also suggest that the following industries be incorporated in the Society’s industry survey programme:

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Yours faithfully,

(Name in BLOCK letters)

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