EPS: IT DEPENDS WHAT YOU MEAN
DO COMPANIES HAVE TOO MUCH ROOM TO MOVE?

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In many instances, accounting practices allow for loose interpretations of reporting requirements. Inconsistencies may leave shareholders less informed than they would like to be.

Accounting standards purport to present a uniform basis for accounts preparation. However, a variety of options remain open. These, combined with some impending changes in accounting standards, may allow for variations in the assessment of key factors such as earnings. The options are often subtle and fall in areas of discretion, such as the amount to be set aside as a provision for bad debts or the depreciable life of assets. Further, while standards have been set to deal with items reported in the accounts, the calculation and disclosure of financial ratios in Australia is not governed by any standards, despite their significance to the market and to the individual shareholder.

Among the most commonly disclosed ratios are earnings-per-share (EPS), the gearing ratio and dividend cover. It is a matter of doubt how comparable these ratios are, not only between companies but also between years for the same company. Both the US and the UK have accounting standards on the calculation and disclosure of EPS. Uniformity in the calculation of financial ratios, and the actual ratios disclosed, is desirable as no consistently reliable comparison of performance or financial strength can be made until such ratios are presented by all public companies on a consistent basis.

A review of a number of Australian annual reports showed that none of the companies reviewed disclosed the method used to calculate such ratios. In some cases, the method could be found only by trial and error by the reader of the report. For example, certain companies calculated EPS including extraordinary profits, while others excluded extraordinary profits. It was also unclear how preference dividends were treated, particularly when preference shares were disclosed as equity and the dividends were treated as an appropriation from profit. The review of annual reports also revealed that a number of companies restated the previous year's ratios, resulting in improved ratios in the current year.

The question of whether financial ratios should be required by accounting standards or the stock exchange is open to debate. These ratios are of particular importance to public companies, where the shareholder is remote from the issues and where ratios are a means of monitoring performance and financial position.

Making disclosure of certain ratios of stock exchange listing could be more appropriate than setting of further accounting standards. These financial ratios are additional information, outside the accounts proper, that is intended to provide for more-informed decisions. If standards are introduced by the stock exchange or the setters of accounting standards, then some form of monitoring would also be required - perhaps by

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including them in the information covered by the audit — to ensure consistency of calculation.

Inconsistencies and difficulty of comparison also arise in the accounts from:
- changes in accounting policies;
- new accounting standards, and areas such as:
- the classification of extraordinary items;
- non-consolidation of subsidiaries and trusts;
- treatment of intangibles;
- different accounting policies among companies in the same industry.

Changes in accounting policies, some of which are a result of changes in or introduction of accounting standards and the consequent accounting treatment, can significantly affect financial ratio comparisons. The introduction of new accounting standards in recent years has resulted in changes in accounting policies by the majority of companies as they have struggled to deal with changing rules for items such as goodwill, leases, foreign exchange and, most recently, debt defeasance.

The introduction of two, slightly different, accounting standards on foreign currency and the introduction of the standard on leasing have had a significant effect on the prior year’s reported earnings for a number of companies. Most companies made an adjustment in their 1988 reports against the opening retained earnings to deal with the adoption of the accounting standards on leases, but many did not restate the prior year’s EPS or gearing ratios. This inconsistency inadvertently allowed comparison between companies. However, it distorted historical figures.

TNT, for example, adjusted its opening retained earnings by $37 million on the introduction of the approved accounting standard on foreign currency, while the Hooker Corporation had an adjustment of $27 million because of the standard on debt defeasance. Neither company made any adjustment to the comparative figures of EPS or gearing. While market analysts may be aware of these factors, the individual shareholder is often not.

Likewise, on the introduction of the approved accounting standard on goodwill, Burns Philip reported an extraordinary loss for write-off of goodwill of $82 million; goodwill had previously been written off directly to a reserve. Other companies chose to amortise goodwill over a period not exceeding 20 years.

A wide variety of terms are applied in the amortisation of goodwill. A shorter period of amortisation obviously will result in lower profits than a longer period. While the accounting standard has sought to introduce a degree of harmony in the treatment of goodwill, varied practices still exist as companies will find arguments to write-off goodwill as an extraordinary item in the year of purchase or adopt varied amortisation terms. Goodwill write-off, as an extraordinary item, significantly distorts reported EPS when other companies amortise goodwill over a number of years.

Extraordinary profits and losses are another frequent source of distortion. Most of the annual reports reviewed disclosed extraordinary items, a large number of which were recurring ones. Lack of extraordinary items was the exception rather than the norm.

CSR, for example, has reported an extraordinary result on sale of land and buildings and investments in each of the four years 1985 to 1988. Pioneer Concrete, in its past three annual reports, disclosed extraordinary results on the sale of non-current assets, disposal of subsidiaries and provision against investments. On the other hand, Qinetex Limited did not report any extraordinary items in the past three years.

Changes being introduced, as the standard becomes an approved standard, are expected to limit the variety of items identified as extraordinary. Fewer items will be disclosed as extraordinary if the standard obtains the effect the standards-setters require; it is likely that more items will, by contrast, be identified as abnormal.

Sales of land and buildings by manufacturing companies, previously often treated as extraordinary, may well be classified as part of earnings under the standard, on the basis that they have either occurred in the past or could well occur in the future. Analysts may well have to revise their assessment of EPS presented by companies or take care to review abnormal items rather than extraordinary items to take out of earnings those items that may not reflect a maintainable earnings stream.

A standard dealing with EPS could overcome this deficiency by clearly defining earnings for EPS purposes. It would also have to deal with a range of other issues currently covered by EPS standards overseas, such as dividends paid to preference shareholders, bonus and right issues, and options.

Any attempt to standardise financial data outside the accounts will have to operate in close conjunction with the related developments of accounting standards. As already mentioned, a standard dealing with EPS could define earnings, but this might be better achieved by tight and consistent definitions of profits, abnormal items and extraordinary items in one accounting standard, leaving a standard on EPS to deal with issues related to the capital base of the calculation. Likewise, while a standard methodology for the calculation of gearing could deal with issues such as the treatment of cash or near-cash assets and the format of the calculation, it would probably require formal accounting standards to identify the assets and liabilities to be brought on-balance-sheet.

Standards have already dealt with some of these issues through, for example, prescribing the treatment of defeasance and set-off. Other issues, such as the use of trusts and other artificial structures, are still under review.

While this paper has highlighted some of the more obvious sources of variation in accounting, profits can still be modified significantly by subjective assessment; for example, of the depreciable lives of assets, or of the quantum of provisions for stock obsolescence or bad debts. So while a degree of certainty and uniformity is important to any reviewer of accounts, it is doubtful whether full comparability can ever be achieved.

Readers of accounts will have to continue to take care to ensure that they understand the assumptions underlying those accounts.

However, there is room for development. This may be as much in the development of standards in the neglected area of financial information not presently forming part of the accounts as in any other field.