Advanced Accounting
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Lesson 11
Analysis of Earnings

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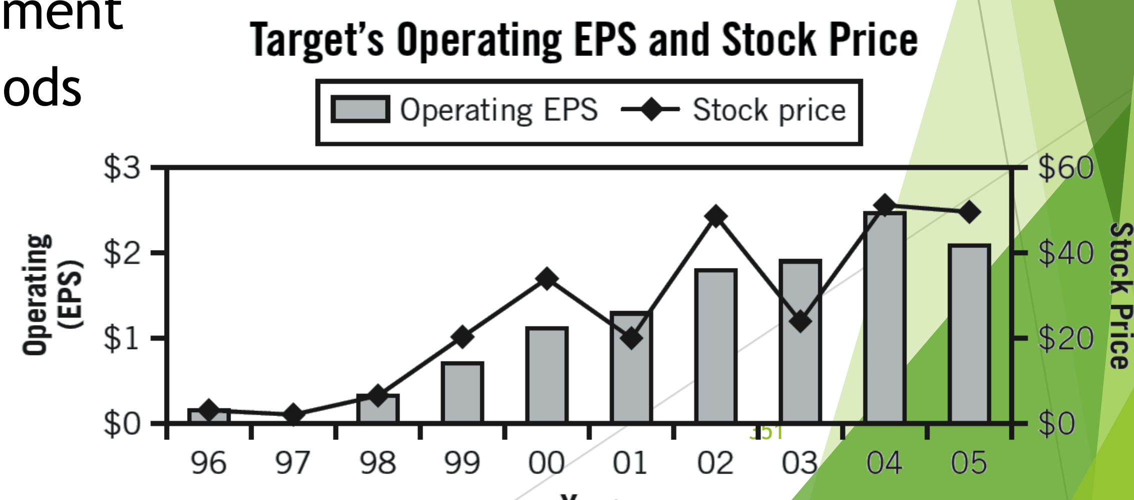
Analysis of Earnings

- ✓ Earnings persistence is a key to effective equity analysis and valuation.
- ✓ Analysing earnings persistence is a main analysis objective
- ✓ Attributes of earnings persistence include:
  - Stability
  - Predictability
  - Variability
  - Trend
  - Earnings management
  - Accounting methods



Analysis of Earnings

- ✓ One of the most widely publicised ratios for a public company is the price/earnings or **PE ratio**.
- ✓ The PE ratio is significant because, by combining it with a forecast of company earnings, analysts can decide whether the shares are currently over- or undervalued.
- ✓ The ratio is published daily in the financial press and is widely employed by those making investment decisions.
- ✓ The PE ratio is calculated by dividing the market price of a share by the earnings that the company generated for that share (**EPS**).
- ✓ Alternatively, the PE figure may be seen as a multiple of the earnings per share, where the multiple represents the number of years' earnings required to recoup the price paid for the share.

Analysis of Earnings

- ✓ The PE ratio for a company will reflect investors' confidence and hopes about the international scene, the national economy and the industry sector, as well as about the current year's performance of the company as disclosed in its financial report.
- ✓ It is difficult to interpret a PE ratio in isolation without a certain amount of information about the company, its competitors and the industry within which it operates.

Analysis of Earnings

- ✓ It is essential that there be a consistent approach to the calculation of the EPS figure.
- ✓ The EPS figure is of major interest to shareholders not only because of its use in the PE ratio calculation, but also because it is used in the earnings yield percentage calculation.
- ✓ It is a more acceptable basis for comparing performance than figures such as dividend yield percentage because it is not affected by the distribution policy of the directors.

$$\text{EPS} = \frac{\text{Earnings}}{\text{Weighted number of ordinary shares}}$$

Analysis of Earnings

IAS 33 (Earnings per share), issued in 1998, revised in 2003.

The standard defines two EPS figures for disclosure:

- **basic EPS** based on ordinary shares currently in issue
- **diluted EPS** based on ordinary shares currently in issue plus potential ordinary shares.

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Basic EPS (IAS 33):

Basic earnings per share is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

Where:

- Net profit is the profit for the period attributable to the parent entity after deduction of preference dividends (assuming preference shares are equity instruments).
- The weighted average number of ordinary shares should be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding, without a corresponding change in resources.
- An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.
- Earnings per share is calculated on the overall profit attributable to ordinary shareholders but also on the profit from continuing operations if this is different to the overall profit for the period.

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What is dilution?

In a modern corporate structure, a number of classes of person such as the holders of convertible bonds, the holders of convertible preference shares, members of share option schemes and share warrant holders may be entitled as at the date of the statement of financial position to become equity shareholders at a future date.

If these people exercise their entitlements at a future date, the EPS would be reduced. In accounting terminology, the EPS will have been diluted. The effect on future share price could be significant. Assuming that the share price is a multiple of the EPS figure, any reduction in the figure could have serious implications for the existing shareholders; they need to be aware of the potential effect on the EPS figure of any changes in the way the capital of the company is or will be constituted. This is shown by calculating and disclosing both the basic and 'diluted EPS' figures.

IAS 33 therefore requires a diluted EPS figure to be reported using as the denominator potential ordinary shares that are dilutive, i.e. would decrease net profit per share or increase net loss from continuing operations.

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Limitations of EPS as a performance measure

EPS is thought to have a significant impact on the market share price. However, there are limitations to its use as a performance measure.

The limitations affecting the use of EPS as an inter-period performance measure :

- ✓ It is based on historical earnings. Management might have made decisions in the past to encourage current earnings growth at the expense of future growth, e.g. by reducing the amount spent on capital investment and research and development. Growth in the EPS cannot be relied on as a predictor of the rate of growth in the future.
- ✓ EPS does not take inflation into account. Real growth might be materially different from the apparent growth.

Analysis of Earnings

Limitations of EPS as a performance measure

The limitations affecting inter-company comparisons:

- The earnings are affected by management's choice of accounting policies, e.g. whether non-current assets have been revalued or interest has been capitalised.
- EPS is affected by the capital structure, e.g. changes in number of shares by making bonus issues.

However, the **rate of growth** of EPS (trend) is important and this may be compared between different companies and over time within the same company.

Analysis of Earnings

- **Price/earnings ratio (P/E)**
  - Market price compared to earnings per share.

$$\text{P/E ratio} = \frac{\text{Market price per share of common stock}}{\text{Earnings per share}}$$

- **Dividend yield**
  - Percentage of market value that is returned as dividends

$$\text{Dividend yield on common stock} = \frac{\text{Annual dividends per share of common stock}}{\text{Market price per share of common stock}}$$

- **Dividend Payout**
  - The ratio of annual dividends declared relative to the earnings per share of the company

$$\text{Dividend Payout} = \frac{\text{Annual dividends per share}}{\text{Earnings per share}}$$