AN INVESTIGATION INTO EARNINGS PER SHARE DISCLOSURES IN SOUTH AFRICA

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ABSTRACT

This dissertation examines Earning per share (EPS) as a disclosure requirement for listed companies by investigating firstly, EPS disclosures in annual reports of certain selected JSE listed companies and secondly, the attitudes of the preparers of those annual reports to a number of issues relating to EPS. The three mandatory EPS disclosures – Basic EPS, Diluted EPS and Headline EPS – are discussed with a view to determining their information content and reporting framework. This study also considers whether cash based measures of performance are better than earnings based measures.

Due to the reliance placed on reported EPS numbers this study attempts, by an examination of annual reports, to provide evidence as to whether or not South African companies are correctly calculating and disclosing the various EPS measures. By means of a questionnaire survey into the attitudes of the preparers of annual reports, this study also attempts to provide evidence as to the importance of the EPS measures as well as the preparers' perceptions on the appropriateness of the Headline earnings definition.

The annual report survey into EPS disclosures revealed that South African companies are correctly calculating and disclosing Basic EPS. Even though all companies correctly calculate Diluted EPS, most companies do not properly disclose Diluted EPS information. As far as Headline EPS is concerned, the annual report survey revealed that many South African companies make disallowed Headline earnings adjustments with most offenders disclosing higher Headline EPS numbers as a result.

The survey into the attitudes of preparers of company reports towards various matters concerning EPS revealed that preparers of annual reports consider Headline EPS to be the most important earnings based measure of performance and the adopted Headline earnings definition as being appropriate. It is therefore important that companies calculate and disclose Headline EPS correctly.

DECLARATION

I declare that "An investigation into Earnings per share disclosures in South Africa" is my own work and that all sources I have used or quoted have been indicated and acknowledged by means of complete references.

K Harrod

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To the incomparable Holy Spirit, thank you for picking me up and restoring my soul. The completion of this dissertation is my personal testimony of your greatness and loving kindness. I say as the psalmist King David, please do not take your Holy Spirit away from me.

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CHAPTER ONE
INTRODUCTION

1.1 Background to the research topic

Listed public companies in South Africa (SA) trade their securities on the JSE Securities Exchange (JSE). Investors trade in such securities with large volumes of shares and other marketable securities changing hands daily. On what basis are shares traded? What makes an investor invest in one particular company as opposed to another? Investors consider various factors and many sources of information. One such source of information is the potential investee's annual financial statements.

Investors invest for different reasons. Some speculate, others are looking for long-term capital appreciation whilst others may be looking for large returns (dividends) on their investment.

Whatever motive the investor has for share dealing, the profitability\earnings of the company, as reported in its annual financial statements, is ordinarily considered. Investors usually analyse the earnings of a company over a time horizon. From the reported historical numbers and announcements by the company as to changes in future operations, investors attempt to project the earnings of the company going forward, and the impact the projected earnings will have on the company's share price and ultimately on their future cash flows.

Earnings per Share (EPS), which is mandatory disclosure for all companies whose securities are publicly traded, is one of the most frequently quoted measures used in assessing company performance in a given period (Scott 1998:11). EPS can roughly be defined as the earnings or profit accruing to each share unit in issue over a reporting period. It relates the profitability of a company over a period to a single share that may be bought, sold or held by an investor. As such investors perceive EPS to be a significant number in a company's annual report.

In SA, listed companies are obliged to disclose three EPS measures. These are:

- Basic earnings per share,
- Diluted earnings per share, and
- Headline earnings per share.

Basic EPS is defined as the net profit for the year (after outsiders' interest, preference dividends and extraordinary items) divided by the weighted average number of ordinary shares in issue over the year (South African Institute of Chartered Accountants (SAICA) 1998a:11). Basic EPS is all encompassing i.e. it includes all items of profit or loss in its calculation, regardless of whether the items are unusual or irregular. Examples of unusual or irregular items affecting Basic EPS are the profit or loss on discontinuance or sale of a division or operation of the company, profits or losses on capital items and extraordinary items as classified by AC 103- Net Profit or Loss For The Period, Fundamental Errors and Changes In Accounting Policies (SAICA 1995a).

If a company has such unusual or irregular items affecting its profit or loss for the period, the Basic EPS number will be misleading as it will not be a fair presentation of the company's earnings from ordinary trading activities.

Diluted EPS is Basic EPS adjusted for potential dilutions in earnings resulting from potential increases in the number of shares in issue and usually arise from outstanding share options and conversions. Diluted EPS attempts to provide shareholders with information relating to the potential dilution in the Basic EPS number and thus the potential risk in the shareholding or investment. As the numerator used for calculating Diluted EPS (earnings) is the same that is used for Basic EPS, Diluted EPS has the same weaknesses as Basic EPS.

Due to the weaknesses of Basic EPS and Diluted EPS, much debate exists over how useful these measures really are. In accounting jurisdictions worldwide, criticisms have over the years been levelled on the earnings figures which have been published by companies (SAICA 2002:15).

Worldwide, attempts have been made by the relevant accounting regulatory bodies to formulate better measures of performance. The calculation and disclosure of Headline

EPS as developed by the United Kingdom Institute of Investment Management and Research (IIMR) in 1993, was the result of one of those initiatives.

Headline EPS seeks to overcome the shortcomings of Basic EPS and Diluted EPS. Headline EPS requires unusual and irregular items affecting profit or loss to be adjusted for in its calculation. Headline EPS attempts to provide investors with a stable and standardized measure of a company's performance from normal trading activities thereby allowing them to make informed investing decisions.

However for Headline EPS to provide meaningful information as to companies' performance, it is imperative that the reporting companies make the correct Headline adjustments as prescribed by the relevant accounting pronouncements. Prior to the issue of Circular 7/2002 - Interpretation of statement of Investment Practice No. 1 - Headline earnings (SAICA 2002), in December 2002, the only accounting pronouncement on Headline EPS was an accounting opinion, AC 306 – Headline earnings: Effect of the issue of AC 103 (revised) on the calculation and disclosure of Earnings per share (SAICA 1995b).

Due to the impact Headline EPS can have on investor decision-making, there is a perception that companies are not making the correct Headline adjustments but rather manipulating the Headline EPS adjustments and consequently disclosing flattering Headline EPS numbers.

1.2 Problem definition

By answering certain important questions on issues surrounding EPS, this study seeks to provide deeper insight into this topic in SA. According to Childs (1971), EPS is the shareholders primary interest as the two benefits that shareholders receive – dividends and market appreciation – both come from EPS (Childs :15). However do investors have a proper understanding of EPS and the issues surrounding it?

This study seeks to provide investors with a better understanding of EPS by discussing what the EPS measures represent, how they are calculated and what the disclosure requirements are. The study will highlight the differences between the different EPS measures as these fundamental differences directly impact investors' decision making.

Is the attention that EPS attracts justified? Are these numbers important? The study also investigates the importance attached to EPS as compared to other measures of performance. Evidence will also be provided as to which EPS measure is most important.

More companies are now disclosing other non-mandatory EPS measures such as Cash flow per share and Diluted Headline EPS. Pretoria Portland Cement's 2002 annual report disclosed eight EPS measures. This study also discusses new EPS measures, their frequency and the differences surrounding their calculations.

Regarding the calculation and disclosure of the EPS measures, there is a perception that companies do not make the correct EPS (especially Headline EPS) adjustments and disclosures in their annual reports. Various commentators such as Childs (1971), Spacek (1972), Hemus and Tindall (1993) and Thomas (2002) believe that companies manipulate their disclosures to show better results. As such this study presents evidence as to whether or not South African companies are properly calculating and disclosing EPS.

Accounting bodies have for some time been trying to come up with better measures of profitability with South Africa adopting the IIMR's definition of Headline earnings in 1995. However do the affected companies agree with this definition of "Headline earnings"? This study will provide evidence as to whether or not South African companies agree with the definition of Headline earnings.

1.3 Research objective and approach

The broad objective of this research is to investigate EPS disclosures and reporting in SA. In achieving the broad objective, this study has the following ancillary objectives:

i. To examine the different EPS measures and the financial reporting framework governing their calculation and disclosure,
ii. To review relevant past literature on EPS,
iii. To determine whether South African companies are correctly calculating and disclosing the various EPS measures,
iv. To determine how important the EPS measures are in comparison to other measures of performance,

v. To determine which EPS measure is most important,

vi. To provide insight into Headline EPS by discussing whether company management:

   a. consider Headline earnings to be a measure of sustainable earnings,
   b. agree with the Headline earnings definition,
   c. believe that Headline EPS is manipulated,
   d. support continued disclosure of Headline EPS in SA, and
   e. consider guidance on Headline EPS to be sufficient.

To achieve the above objectives, the study is conducted in two main parts.

Objectives one and two are addressed in the first part of the study. In the first part an attempt is made to enhance knowledge of and to give insight into the subject of EPS reporting. The discussion is also intended to provide knowledge for the research carried out in the second part of the study. To attain this, the subject is first placed within a proper financial reporting and theoretical frame of reference.

Here the progress of accounting standards relevant to the subject is first discussed followed by an examination of current accounting pronouncements on EPS. Each of the three EPS measures is then examined separately, discussing specific matters affecting the calculation of each. The study shows how each measure is calculated and why each is so different from the others.

In the discussion of Headline EPS, the study shows how Headline earnings was developed in the UK and why it so necessary in today's reporting climate. The study then discusses the characteristics that underlie the definition of Headline earnings. In dealing with the definition of Headline earnings, the additional guidance provided by Circular 7/2002 is considered.

The first part of the study concludes with a literature review on EPS. Here the relevance of past empirical research to this study is examined.

The second part of the study seeks to address objectives three through to six. Here EPS is empirically investigated. Two separate empirical studies are done. For purposes of these studies, the sample selected was the Financial Mail's "Top 100" Industrial companies of 2000.

The first empirical study involves reviewing the selected companies' annual reports to check reported disclosures against prescribed disclosures. This provides evidence as to whether companies are complying with the disclosure requirements of the regulatory accounting bodies and whether companies are correctly applying the definition of Headline earnings.

The second empirical study takes the form of an opinion research survey whereby company managements' attitudes towards EPS are investigated. This part of the study provides evidence as to:

i the importance attached to EPS by company management,
ii which EPS measure company management think is most important,
iii whether company management agree with the definition of Headline earnings,
iv whether company management believe Headline EPS numbers are manipulated in SA and
v whether company management feel that Headline EPS should continue to be disclosed in SA.

1.4 Importance of the research

EPS numbers are widely quoted in capital markets as a first guide to company performance. The importance of the research is that it attempts to give investors a better understanding of these measures.

Even though EPS reporting attracts considerable interest, little empirical research has been done on EPS and Headline EPS in SA, especially from an accounting perspective. This study attempts to fill this gap in literature by firstly providing a solid theoretical and financial reporting foundation on the subject of EPS. In the second part of the study, empirical evidence will be provided on EPS reporting in SA.

Research into the importance of the three EPS measures as perceived by the preparers of listed company reports has not previously been done in SA. This study investigates the preparers' attitudes toward the importance of the EPS measures, providing valuable information as to South African company management behaviour regarding EPS disclosures.

This survey also provides valuable evidence as to whether or not South African companies are in fact making incorrect EPS adjustments and disclosures.

The research also aims to provide the standard setters, both local and international, of the regulatory bodies responsible for statements of Generally Accepted Accounting Practice (GAAP) with information regarding company management's perceptions as to the Headline earnings definition and disclosures.

1.5 Organisation of the study

This study comprises seven chapters which are divided as follows:

Chapter one: Introduction

This chapter presents the background to the research topic, the reason for and the objectives of the study, the importance of the research and the organisation of the study.

Chapter two: Background to and current position of EPS in SA

By examining the relevant accounting pronouncements on EPS, this chapter discusses the various EPS measures. This chapter discusses the information content of each of the EPS measures, how they are calculated as well as their disclosure requirements. The development of and complexities surrounding the Headline earnings definition is also considered in this chapter.

Chapter three: Significant prior research on EPS

This chapter reviews relevant previous research on EPS. Research into the correlation between EPS and share prices, the use of EPS in financial analysis, the susceptibility of EPS to manipulation and other areas are presented and evaluated. By presenting the views of various commentators, this chapter also discusses whether cash based per share measures are better than earnings based measures.

Chapter four: Methodology

This chapter discusses the methodology used for investigating company compliance with EPS disclosures and the methodology used for investigating users' attitudes towards EPS reporting. The research design, survey objectives, target groups, data collection techniques and other related matters are discussed in this chapter.

Chapter five: Presentation and analysis of financial statement survey results

This chapter presents the results of the financial statement survey into company compliance with EPS disclosures. The frequency of disclosure of other EPS measures and possible reasons for their disclosure are also examined in this chapter.

Chapter six: Presentation and analysis of questionnaire results

This chapter presents the analysis and evaluation of the research findings with respect to the importance of the EPS measures, the appropriateness of the Headline earnings definition, the perceived manipulation of Headline EPS and the continued disclosure of Headline EPS.

Chapter seven: Summary, conclusions and recommendations

The study concludes with a summary of the main research findings. Conclusions derived from the study and recommendations to address areas of concern revealed by the study are presented in this chapter.

CHAPTER TWO

BACKGROUND TO AND CURRENT POSITION OF EPS IN SA

2.1 Introduction

The purpose of this chapter is to provide an overview of the EPS reporting framework, an understanding of which is needed to evaluate the results of investigations into EPS reporting practices and attitudes as conducted later on in the study. The overview of the EPS reporting framework is achieved by examining the relevant local and international accounting statements, guidelines and circulars on EPS.

In addition to examining the disclosure requirements of each of the EPS measures, the objective and information content of each EPS measure are discussed so as to show their usefulness. This chapter also looks at the common voluntary EPS measures as well as the international position on EPS reporting.

Before examining the accounting pronouncements themselves, it is necessary to state the statutory framework governing disclosures prescribed in accounting pronouncements. The Companies Act, 1973, as amended, obliges all South African companies to produce annual financial statements in accordance with South African Statements of Generally Accepted Accounting Practise (GAAP) (Companies Act schedule 4:5). As such the EPS disclosures and discussions in the relevant accounting pronouncements represent the EPS reporting framework.

The EPS reporting framework (accounting pronouncements) is examined below.

2.2 AC 104 - Earnings per share

2.2.1 Background and objective

In 1992 SAICA issued AC 104 - Earnings and Dividends per share, the first South African statement on EPS. In 1995 SA committed itself to a process of harmonising local standards with international standards. AC104 - Earnings and Dividends per Share (SAICA 1992) was thus redrafted based on the International Accounting Standard (IAS)

33 – Earnings per share (International Accounting Standards Committee (IASC) 1997) and a revised AC 104 - Earnings per share (SAICA 1998a), was issued. In principle the revised AC 104 is identical to IAS 33.

AC 104 applies to all companies whose securities are publicly traded as well as companies who choose to voluntarily disclose EPS information. AC 104 provides guidance for the calculation of Basic and Diluted EPS only.

The disclosure of other EPS measures which may help users better evaluate company performance is however encouraged (SAICA 1998a:53). Unlike the superseded AC 104, the revised AC 104 does not require the disclosure of Dividends per share. However listed companies still have to disclose Dividends per share in terms of the Companies Act (schedule 4:42{1}) and AC 101 (SAICA 1998b:86).

AC 104 states that its objective is to "prescribe principles for the determination and presentation of Earnings per share, which will improve performance comparisons among different enterprises in the same period and among different accounting periods for the same enterprise" (SAICA 1998a:1).

The first paragraph of AC 104 states that the focus of the statement is on the on the denominator of the EPS calculation (SAICA 1998a:1). Paragraph one states further that "even though earnings per share data has limitations because of different accounting policies used for determining earnings, a consistently determined denominator enhances financial reporting" (SAICA 1998a:1).

The rationale is that if the denominator can be calculated on a standardised basis, then providing adequate and proper disclosure of material items affecting profit or loss, the users (financial analysts) can decide on their own measure of profit to be used in their forecasts and comparisons.

2.2.2. Basic EPS

2.2.2.1 Objective

Basic EPS is more important than the overall reported profit figure. As an illustration consider the following:

It will be an achievement for any company board to double profits in a year. However if over the same period the company quadruples the number of shares in issue, is that a good thing? The answer is no, doubling profits is good, but suddenly the number of shares on the market has been multiplied by four. The value of a share is now halved.

Whilst the illustration may be extreme it's not uncommon for companies to acquire other companies and issue shares as the consideration. The disclosure of Basic EPS is intended to provide a better measure of earnings than reported profit.

2.2.2.2 Calculation

Basic EPS is calculated by dividing Basic earnings by the weighted average number of ordinary shares in issue over the period (SAICA 1998a:11).

Basic earnings is the net profit or loss for the year attributable to the ordinary shareholders. It is after extra-ordinary items, tax, preference dividends and outside shareholders' interests.

The inclusion of extra-ordinary items in the calculation of Basic EPS represented a significant difference from the superseded AC 104 which excluded extra-ordinary items in its calculation.

Regarding the denominator, the number of shares is weighted so as to reflect the fact that the share capital which contributed to the profit or loss for the year, may have increased or decreased during the year.

2.2.2.3 Basic EPS as a measure of performance

Basic EPS includes all items affecting profit or loss in its calculation. There are no exemptions. Clearly if an enterprise has material capital, "exceptional" or irregular items affecting its profit or loss, the Basic EPS number will be not be a true measure of company performance from trading activities. As an example. if a company sells of a division at a significant profit, this profit will distort Basic EPS.

However there are merits to the disclosure of Basic EPS. The amendments made to the definition of Basic EPS by AC 104 (SAICA 1998a), i.e. including all items of profit or loss in the calculation of Basic EPS, intend to put the calculation of Basic EPS on a standardised basis and to improve fair presentation of reported EPS numbers. By defining Basic EPS on a standardised basis, it can be safely used as a starting point for further analysis.

2.2.3. Diluted EPS

2.2.3.1 Objective

AC 104 requires Diluted EPS to be disclosed where there are outstanding ordinary share options or ordinary share conversion rights attached to financial instruments like as convertible debentures or preference shares.

The objective for calculating and disclosing Diluted EPS is to give investors a measure of the return on their investment taking into potential increases in the number of ordinary shares in issue.

2.2.3.2 Calculation

Diluted EPS is calculated by dividing Diluted earnings by the potential weighted average number of shares that could be in issue in the future.

Diluted earnings is Basic earnings adjusted for changes to profit or loss that would have resulted if the option or conversion rights had been exercised, for example if there were convertible debentures in issue at the beginning of the year, the after tax interest on the debentures would have to be added back to Basic earnings in order to arrive at Diluted earnings.

The denominator used in calculating Diluted EPS is the denominator used in calculating Basic EPS plus the weighted average number of shares that would have to be issued if all dilutive option and/or conversion rights were exercised.

2.2.3.3 Diluted EPS as a measure of performance

As Diluted EPS is an adjusted Basic EPS measure it has the same shortcomings as Basic EPS. Everingham and Watson state that diluted EPS is not intended to be an estimate of future earnings, but it is a factor that should be taken into account when making future projections of EPS (1999:7.13).

The difference between Basic and Diluted EPS is intended to give investors an indication as to the potential dilution in their investment. The larger the difference, the greater the risk of dilution in their earnings. As such Diluted EPS is more of a warning signal than a measure of performance (Everingham and Watson 1999:7.14).

2.2.4 Disclosure requirements for Basic and Diluted EPS

The disclosure requirements for Basic and Diluted EPS are as follows:

- ✓ Basic and Diluted EPS should be disclosed for each class of ordinary share that has a different right to share in profits (SAICA 1998a:48),
- ✓ Basic and Diluted EPS should be disclosed on the face of the income statement with equal prominence (SAICA 1998a:48),
- ✓ The amounts used as numerators should be disclosed, and a reconciliation of the numerators used to net profit or loss for the period should be disclosed (SAICA 1998a:50) and
- ✓ The amounts used as denominators should be disclosed, and a reconciliation of these denominators to each other should be also disclosed (SAICA 1998a:50).

2.3. Headline EPS

2.3.1 Background

Prior to the issue of AC 306- "Headline earnings- effect of the issue of AC 103 (revised) on the calculation and disclosure of Earnings per share" (SAICA 1995b) in 1995, South African companies were not required to disclose Headline EPS. The need for a better measure of company performance became relevant when AC 103 - Net profit or loss for the period, fundamental errors and changes in accounting policies, was revised in 1995.

The superseded AC 103 (SAICA 1985) allowed for "exceptional items" and "abnormal items" to be classified as "extra-ordinary items" and as the earnings calculation of the superseded AC 104 (SAICA 1992) excluded extra-ordinary items in its calculation, companies were abusing the classification of exceptional items i.e. regarding items as exceptional when they were a loss and regarding items as non-exceptional when they were a profit.

The revised AC 103 (SAICA 1995a) narrowed the definition of extra-ordinary items with the result of making the majority of items previously classified as extra-ordinary being reported above the line in the Basic EPS calculation. Extra-ordinary items are now defined as items of income or expense that arise from events that are clearly distinct from the ordinary activities of the enterprise. Examples of such events are the expropriation of assets and natural disasters like earthquakes and floods (SAICA 1995a:13).

This amendment to AC 103 (SAICA 1995a) created the possibility of a significant change to a company's reported Basic EPS in the first reporting period for which the statement became effective. The Basic EPS number would also be more volatile in future reporting periods as well.

2.3.2 AC 306 – Headline EPS

In response to the impending volatility to reported Basic EPS numbers and in order to provide a better measure of company performance, the Accounting Issues Task Force issued AC 306 in 1995 and encouraged companies to disclose Headline EPS in addition to Basic and Diluted EPS. The JSE listing requirements were subsequently amended obliging all listed companies to disclose Headline EPS.

For the purposes of calculating Headline earnings, AC 306 adopted the definition of Headline earnings as defined by the United Kingdom Institute of Investment Management and Research (IIMR). The IIMR, now the United Kingdom Society of

Investment Professionals (UKSIP), is the professional body representing investment analysts and fund managers in the UK. UKSIP addressed the definition of Headline earnings in their Statement of Investment Practice (SIP) No 1- Headline earnings. The definition of Headline earnings, as formulated by UKSIP, is discussed at 2.3.4.5.

Headline EPS is calculated by dividing Headline earnings, as defined by UKSIP, by the weighted average number of shares in issue over the period. The denominator is the same as for Basic EPS.

The disclosure requirements for Headline EPS are as follows:

- ✓ An itemised reconciliation between Headline earnings and Basic earnings disclosing for each reconciling item the nature and amount of each reconciling item (SAICA 1995b:15) and
- ✓ Management is *encouraged* to give a discussion, commentary and analysis of the main features underlying the calculation of Headline EPS (SAICA 1995b:15)

AC 306 does not specify that Headline EPS need be disclosed on the face of the income statement so disclosure in the notes would suffice. In addition to disclosing the amount and nature of each reconciling item, the illustrative example appendixed to AC 306 also shows for each reconciling item:

- ✓ the tax effect and
- ✓ the effect on outsider shareholders' interests.

2.3.3 Circular 7/2002

In December 2002 AC 306 was withdrawn and replaced by Circular 7/2002- Interpretation of Statement of Investment Practice No.1 - Headline earnings (SAICA 2002).

The circular resulted from a joint project between UKSIP and professional bodies in SA and is merely an interpretation of the UK's SIP 1- Headline earnings.

As such AC 306 and Circular 7/2002 adopt the same definition for Headline earnings. Circular 7/2002 does however offer additional commentary on the definition of

Headline earnings due to the issue of new accounting statements since the issue of AC 306. Attached to the interpretation is the UK's SIP 1. Circular 7/2002 became effective on issue.

UKSIP's definition of Headline earnings is examined in the following section.

2.3.4 UKSIP Headline earnings

2.3.4.1 Background

SIP No.1 was issued in the UK to address changes to the definition of Basic earnings that resulted from amendments to the UK's Financial Reporting Standard (FRS) 3- Reporting Financial Performance (Institute of Chartered Accountants, England and Wales (ICAEW) 1993), the equivalent to South Africa's AC 103.

The amendments made to FRS 3 were similar to those made to AC 103 i.e. the definition of extra-ordinary items was narrowed to exclude "exceptional items". Due to the impact those changes would have on Basic EPS, a decision was undertaken by professionals in the UK to develop a better measure of performance.

2.3.4.2 Development of a better measure of performance - Headline earnings

UKSIP 1 states that any attempt to define a single earnings measure that can be used for all purposes is bound to fail (SAICA 2002:11). The definition of (Headline) earnings arrived at does not have to "refer to an ideal, and in fact non-existent, number but only to a number chosen for some specified purpose and different purposes may lead to different numbers" (SAICA 2002:11).

Regarding the development of a better measure of performance FRS 3 states that "it is not possible to distil the performance of a complex organisation into a single measure" (ICAEW 1993:52). Undue significance should therefore not be placed on any one measure of performance but rather all components of a company's activities should be assessed.

In developing a better measure of performance, UKSIP 1 draws a distinction between the following two earnings measures:

- A sustainable/maintainable earnings measure and
- A factual Headline earnings measure.

2.3.4.3 Sustainable/maintainable earnings

SIP 1 states that maintainable earnings is a measure of earnings that can be sustained in the future (SAICA 2002:12). Calculating sustainable earnings requires an analysis of historic results as a basis for assessing the future. Such a measure would necessitate significant adjustments to published figures which would require a degree of estimation and judgement. Also all non-continuing items would have to be removed.

Due to the extent of the adjustments that would be necessary and the degree of judgement that would have to be exercised in calculating maintainable earnings, UKSIP 1 states that the calculation of sustainable earnings cannot be put on a standardised basis but will rather vary from company to company and on the intended use of the measure (SAICA 2002:21).

2.3.4.4 A factual "Headline earnings" measure

Even though it is undesirable to formulate a definition for maintainable earnings it is desirable to define a measure of earnings that can be used as "an unambiguous reference point" between company management, investors, financial analysts and the press (SAICA 2002:22).

A suitable measure for earnings should have the following characteristics:

i. it should be a measure of trading performance,
ii. it should be robust and
iii. it should be factual (SAICA 2002:13).

Each characteristic can be further elaborated as follows:

<u>Measure of trading performance</u>

The measure should encompass the performance of the company from ordinary trading activities. Profit and loss items should be classified between trading and non-trading and/or capital and non-capital. This distinction is made regardless of whether or not the item/s are exceptional or likely to reoccur.

Non-trading and/or non capital items must be excluded.

Robust

The calculation should be able to be carried out by anyone given the building blocks in the financial statements. In order to ensure comparability between companies, calculation of the measure must not be open to interpretation.

Factual

The measure should be based on items of profit or loss that have actually been reported in the period i.e. no theoretical adjustments should be made in calculating the measure.

2.3.4.5 Headline earnings definition

Based on the above characteristics, UKSIP 1 defines this "factual earnings measure" as "Headline earnings". This is the same definition used in AC 306 and Circular 7/2002. Relevant additional commentaries included in Circular 7/2002 are included in italics.

i. All the **trading** profits of the company for the year (including interest) should be **included** in the earnings number. **Abnormal/exceptional** trading items should also be **included** (SAICA 1995b:11{a}, SAICA 2002:20).

ii. Profits or losses from **discontinued operations** or operations acquired during the year should be **included**. Profits or losses from the **discontinuance itself** should be **excluded** (SAICA 1995b:11{b}, SAICA 2002:21).

   "Discontinued operations" include operations to be discontinued in the future SAICA 2002:1). Profit or loss on the discontinuance itself include:

   - *Employee termination costs,*
   - *Gains or losses on the disposal of assets or settlement of liabilities relating to the discontinued operation,*
   - *Penalties and cancellation of contract costs and*
   - *Site rehabilitation costs (SAICA 2002:1)*

iii. Gains and losses from the **sale of or adjustment to the fair value of assets** should be **excluded**. This does not apply to assets acquired for resale such as marketable securities (SAICA 1995b:11{c}, SAICA 2002:22).

Gains or losses on the disposal of or adjustment to the fair value of financial instruments should be dealt with in accordance with the company's accounting policy for financial instruments i.e. if the gains or losses are recognised in the income statement they should be included in Headline earnings, if the gains or losses are recognised in equity then they will be excluded from Headline earnings (SAICA 2002:3).

iv. Profits or losses from the **reorganisation or redemption of long term** debt should be **excluded** (SAICA 1995b:11{d}, SAICA 2002:23).

v. **Prior period adjustments** resulting from changes in accounting policies and fundamental errors should be **excluded** (SAICA 1995b:11{e}, SAICA 2002:24).

vi. The following **provisions** should be **excluded** so as to **charge the expense in the year the in which it occurs** (SAICA 1995b:11{f}, SAICA 2002:25)

    i. profits or losses on the sale or termination of an operation,
    ii. restructuring and reorganisation costs, and
    iii. profits or losses on sale of assets.

As the introduction of AC 130 - Provisions, contingent liabilities and contingent assets (SAICA 1999) has led to a clear definition of provisions as genuine liabilities incurred during the year it is now not necessary to reverse the provisions as required by SIP 1. However this does not apply to provisions relating to profits or losses on discontinuance of a division, as this is still a capital item it is excluded from Headline earnings (SAICA 2002:5).

Even though the treatment of provisions in Circular 7/2002 is different to the treatment of provisions in SIP 1 and AC 306, the difference relates more to whether or not there is an actual present obligation (liability) rather than a difference in methodology. As provisions are now only raised for actual liabilities incurred during the year, they are included in Headline earnings.

vii. The amortisation of **goodwill** and adjustments to its fair value should be **excluded** from Headline earnings (SAICA 1995b:11{g}, SAICA 2002:26)
The amortisation of other intangible assets should be included in Headline earnings (SAICA 2002:6).

viii. **Pension fund costs** relating to continuing operations should be **included** in Headline earnings (SAICA 1995b:11{h}, SAICA 2002:27).
AC 116 - Employee benefits (SAICA 2001) allows the additional liability that results from a change from a defined benefit plan to a defined contribution plan to be written in the year of the change or on a straight line basis over 5 years. This expenditure is excluded from Headline earnings (SAICA 2002:6).

ix. Capital and trading items which arise in foreign currencies should be treated the same as if they arose in the reporting currency (SAICA 1995b:11{i}, SAICA 2002:28).
The realization of a foreign currency translation reserve on the disposal of a foreign entity should be excluded from Headline earnings as it is regarded as a capital item (SAICA 2002:7).

x. Headline earnings should be adjusted for tax effects and outside shareholders interests relating to items excluded from Headline earnings (SAICA 1995b:11{j}, SAICA 2002:29).

xi. Other than adjustments to tax relating to items excluded from Headline earnings, Headline earnings should reflect the tax charge in the income statement (SAICA 1995b:11{k}, SAICA 2002:30)
The effects of a change in tax rate should be included in Headline earnings (SAICA 2002:7).

xii **Extra-ordinary items** should be **excluded** from Headline earnings (SAICA 1995b:11{l}, SAICA 2002:31).

2.3.5 Headline EPS illustrative example

The need for Headline EPS adjustments is best demonstrated by means of an example. The following information was extracted from Iscor Ltd's 2002 annual report.

Table 2.1: Extract of disclosures from Iscor Ltd's 2002 annual report – Basic EPS

	2002	**2001**
Net profit/(loss) attributable to ordinary shareholders	R 4 141m	(R 725m)
Weighted average number of shares	345m	301m
Basic EPS	1 200c	(241c)

In the absence of Headline EPS, the company appears to have performed dissimilarly in 2001 reporting a Basis loss per share of R 2,41. In 2002 the company appears to have had a drastic turn around reporting a Basic EPS of R 12. However the Headline EPS numbers show a completely different situation.

Table 2.2: Extract of disclosures from Iscor Ltd's 2002 annual report - Headline EPS

	2002	**2001**
Headline EPS	139c	188c

When the Headline earnings definition is applied and the headline adjustments made, it is evident that the company's *trading* performance has been relatively constant. Table 2.3 presents Iscor Ltd's Headline earnings reconciliation.

Table 2.3: Extract of disclosures from Iscor Ltd's 2002 annual report - Headline earnings reconciliation

	2002	2001
	Rm	Rm
Basic earnings	**4 141**	**(725)**
Headline adjustments		
Negative goodwill realised	(2 585)	-
Goodwill amortisation	-	67
Associates exceptional items	-	(14)
Surplus/(loss) on sale of investments	(364)	9
Surplus on sale of residential properties	(52)	(49)
Loss on disposal of property, plant and equipment	-	245
Surplus on sale of division	-	(81)
Increase in provision for loss on discontinuance	-	47
Restructuring costs	118	31
Reversal of impairment loss/(impairment loss)	(998)	1 500
Tax effects of adjustments	220	(465)
Headline earnings	**480**	**565**

The example clearly shows that Basic EPS can be very misleading and that Headline EPS is a better measure of <u>trading</u> performance than Basic EPS.

2.3.6 Adoption of Headline EPS in SA

Headline EPS has been adopted in SA as a standard definition for the announcement of company results (SAICA 2003a:1). According to John Burke, head of listings at the

JSE, of the EPS measures presented by companies, only Headline EPS is captured by the JSE (De Klerk 2003:25).

2.4 EPS internationally

Basic and Diluted EPS

In 1990 at the suggestion of the International Organisation of Securities Commission (IOSCO) and several member bodies of the International Accounting Standards Committee (IASC), the IASC started a project to formulate an international standard on EPS. It was the first project undertaken in conjunction with the International Co-ordinating Committee of the Financial Analysts Association. (Everingham and Watson 1999:7.2). Their efforts resulted in the issue of IAS 33 (IASC 1997) - Earnings per share, the first IAS on EPS.

IAS 33 as well as other IASs were issued by the International Accounting Standards Committee from 1973 to 2000. The International Accounting Standards Board (IASB) replaced the IASC in 2001 (www.iasplus.com/standard/.htm). The IASB re-issued IAS 33 in 2003. There are no significant differences between the IASs issued in 1997 and 2003.

The United Kingdom's standard FRS 14 - Earnings per share and the United States' (US) Financial Accounting Standard (FAS) 128 - Earnings per share are both based on IAS 33.

As from January 2005 South Africa, Australia, the UK as well as other countries in the European Union will be adopting the International Accounting Standards as the basis for the preparation of annual reports in these countries (www.accaglobal.com/publications/hsr/52/925027). Provided that the local EPS statements in these countries are currently based on IAS 33 (as is the case with SA and the UK), this convergence should not have much impact on EPS reporting in these countries.

Headline EPS

IAS 33 does not require the disclosure of Headline EPS. Even though Headline EPS was developed in the UK, Headline EPS is not mandatory disclosure for companies in the UK (Davies 1998:1343). However Headline EPS is recommended disclosure in the UK (Davies 1998:1343). There is no requirement for companies in the US to disclose Headline EPS.

2.5 Voluntary EPS measures

As discussed earlier, AC 104 does encourage the disclosure of other EPS measures. While no examples are quoted in the statement itself, other EPS measures commonly found in annual financial statements include Diluted Headline EPS and Cash flow per share.

Where an enterprise discloses other EPS measures, AC 104 gives the following guidance:

- The denominator used must be the same that is used for calculating Basic EPS and
- Where the numerator used is not a line item in the income statement, a reconciliation must be disclosed between the numerator used and a line item in the income statement (SAICA 1998a:52).

2.5.1 Cash flow per share

There is no standardised calculation for Cash flow per share. Regarding the denominator, the number of shares that must be used must be the same that is used for Basic EPS (SAICA 1998a:52).

Everingham and Watson (1999) comment that as the numerator can be calculated in a variety of ways, it is necessary that cash based EPS figures are clearly defined and reconciled back to a figure reported in the financial statements (Everingham and Watson 1999:7.25).

Two examples of the way the numerator is found to be calculated in practice follow:

Earnings based

This cash flow measure is usually called "Cash equivalent EPS". Basic earnings is used as the starting point with adjustments for non-cash items like deferred taxation, depreciation, amortization and profit/loss on disposal of fixed assets.

Cash based

This cash flow measure is usually called "Attributable cash flow per share". The net cash flow from operating activities, per the Cash Flow Statement, is used as the starting point with deductions for tax, preference dividends and minority shareholders interests. This measure thus focuses on the actual cash stream for the year under review.

2.5.2 Diluted Headline EPS

Even though Diluted EPS takes into account potential dilutions in Basic EPS, it is somewhat flawed as it does not eliminate non-trading or capital items from its calculation, in the way that Headline earnings adjustments does to Basic earnings. To overcome this some companies make Headline earnings adjustments to Diluted earnings and report Diluted Headline EPS. The denominator is the same as for Basic EPS.

2.6 Recent developments

As mentioned, SAICA is in the process of aligning local statements of GAAP with International Accounting Standards. AC 103's equivalent international statement is IAS 8 (IASB 2003). Unlike AC 103 (SAICA 1995a), IAS 8 (IASB 2003) does not allow for certain events to be classified as "extra-ordinary". Including items previously classified as extra-ordinary in net profit/loss for the year (Basic earnings) makes the disclosure of Headline EPS even more necessary, as Basic EPS will be more distorted if those events occur during the reporting period.

Based on the concept of "comprehensive income", the IASB is working on a new format for the income statement. The new format will contain all changes in net assets (shareholder's funds) other than transactions with owners (SAICA 2003b). The new format will see the income statement disclosed in a columnar format with a distinction between income flows (disclosed in column 1) and remeasurement (disclosed in column 2). These two columns will then add up to comprehensive income (De Beer 2003:11).

2.7 Summary

This chapter examined the relevant accounting pronouncements on EPS. Problematic issues surrounding EPS have been discussed including the definition of Headline earnings.

The following summary points can be made:

Basic and Diluted EPS

- AC 104 is identical to IAS 133,
- Where there are abnormal, exceptional or capital items affecting profit or loss for the year, Basic EPS can be misleading and
- Diluted EPS is more of a warning signal than a measure of performance.

Headline EPS

- Company performance is reflected in a range of information rather than a single measure,
- Maintainable earnings cannot be put on a standardised basis,
- Headline earnings is intended to provide an "unambiguous reference point" to users, and
- In calculating Headline earnings, certain **specified** non-trading and capital items are excluded from profit or loss for the year.

The following chapter reviews relevant previous research into EPS.

CHAPTER THREE
SIGNIFICANT PRIOR RESEARCH ON EPS

3.1 Introduction

The previous chapter discussed the EPS share reporting framework. The purpose of this chapter is to examine relevant previous research on Earnings per share. In addition to providing insight into other areas in relation to EPS, the literature review shows the usefulness of EPS.

The focus of prior research has been on the relationship between share prices and EPS with several researchers investigating the correlation between share prices and EPS. In studying the exploratory power of EPS on share prices, detailed statistical investigations have been conducted. If share prices and EPS are correlated, it would indicate that the disclosure and analysis of EPS is important.

The literature review also revealed growing support for cash based per share measures ahead of earnings based per share measures. The main reason quoted by those criticising earnings based per share measures is that the susceptibility of earnings to manipulation reduces the reliance that can be placed on earnings based measures of performance.

The above areas of research as well as other areas of research are discussed below.

3.2 Correlation between EPS and share prices

Relevant studies on the correlation between EPS and share prices are discussed below.

3.2.1 Hemus and Mildenhall – 1994

As mentioned in chapter two, the revised AC 103 (SAICA 1995a) narrowed the definition of extra–ordinary items significantly. Whilst the revisions were still being exposed, analysts expressed concern that the possible volatility of future EPS numbers might adversely affect EPS as an analytical tool. Hemus and Mildenhall thus decided to study the impact of the revised definition on EPS as a measure of share performance.

The study investigated the correlation between share prices and three EPS measures for a sample of companies listed on the industrial sector of the JSE from 1986 to 1992. The three EPS numbers used were:

1. The actual EPS number as reported by the companies.
2. The EPS number that would have been reported had the narrower definition of extra–ordinary items been used. This EPS measure was called "measure 1".
3. The reported EPS measure adjusted for certain non-cash flow items like goodwill amortizations and profits and losses on sale of assets. This measure is similar to the current Headline EPS (AC 306 was only issued in 1995). This measure was called "measure 2".

The adjusted EPS numbers were calculated by analysing the contents of the extra-ordinary items note in the selected companies' annual reports and reclassifying them for purposes of the study.

Hemus and Mildenhall found that none of the three EPS measures were consistently superior as an indicator of share performance over the years of the study. However reported EPS and "measure 1" yielded the same average correlation with share prices over the seven years of the study. Measure 2 was found to show the best correlation with share prices (1994:37).

Hemus and Mildenhall highlighted that their review revealed an abuse of extra-ordinary items by companies. They found that companies were incorrectly classifying loss items as extra-ordinary and that there was inadequate disclosure of items making up "extra-ordinary item" as disclosed on the face of companies' income statements (1994:37).

Green (1992) stated that reported earnings figures were unreliable as companies "fudge" their results by putting losses into extra-ordinary items (Green 1992:23), thus supporting the finding by Hemus and Mildenhall.

Based on the results of their review, Hemus and Mildenhall concluded that the revised definition of extra-ordinary items would not adversely affect EPS as an analytical tool, as feared by analysts. Rather the narrowed definition of extra-ordinary items would have the advantage of eliminating the scope that companies had at that time for distorting reported EPS numbers (1994:36).

The Hemus and Mildenhall study also showed that a measure similar to Headline EPS (measure 2) was most correlated with share prices. This may indicate that Headline EPS has more market usefulness (explanatory power) than Basic EPS.

3.2.2 Demsetz - 1995

Due to criticisms surrounding the usefulness of accounting returns and uncertainty as to the relationship between EPS numbers and share prices, Demsetz conducted a study to determine whether there was any correlation between share prices and EPS.

Demsetz selected 489 manufacturing companies listed on the US stock exchange over a twenty year period covering 1962 to 1981. Only companies which were listed for this entire duration were selected. A multiple linear regression was formulated for each of these years with the share price as the dependent variable and the corresponding EPS numbers as the explanatory variable.

The statistics generated by Demsetz showed a significant correlation between share prices and EPS (1995:104). Demsetz concluded that EPS has considerable information content for relative share prices (1995:104).

3.2.3 Balsam and Roland – 1998

In addition to studying the strength of the relationship between share prices and EPS, Balsam and Roland also investigated whether Basic EPS or Diluted EPS was more correlated with share prices.

Their study covered the nineteen year period 1975 to 1993. All US listed companies who disclosed unequal Basic and Diluted EPS numbers were selected. These companies did not have to be listed for the full 19 years. The dependent variable in the regression analysis was the respective companies' closing share prices on the 31st of December each year. Correlation coefficients were then calculated for Basic and Diluted EPS for each of the 19 years.

The correlation coefficients as calculated by Balsam and Roland and presented by them on page 241 of their study are summarized in table 3.1. The results show that Basic EPS and Diluted EPS are both highly correlated with share prices. Also the Regression R's for Diluted EPS exceed those for Basic EPS in all 19 years.

Balsam and Roland concluded that the market values EPS as a meaningful measure of performance with both Basic and Diluted EPS "significantly associated with stock price" (1998:235). They also found that Diluted EPS is more informative than Basic EPS (1998:247).

Table 3.1: Balsam and Roland (1998) study - Correlation coefficients of share price on Basic EPS and Diluted EPS

Year	Regression R's	
	BEPS	DEPS
75	0.54	0.60
76	0.63	0.69
77	0.60	0.66
78	0.56	0.58
79	0.46	0.54
80	0.27	0.27
81	0.65	0.69
82	0.52	0.56
83	0.52	0.53
84	0.71	0.75
85	0.50	0.63
86	0.30	0.48
87	0.34	0.41
88	0.53	0.57
89	0.42	0.48
90	0.25	0.27
91	0.46	0.48
92	0.62	0.65
93	0.67	0.72
Average	0.50	0.56

Source: Balsam and Roland (1998:241).

3.2.4 De Villiers et al – 2003

De Villiers et al decided to apply the linear regressions developed by Demsetz (1995) to South African listed shares. Based on the procedure developed by Demsetz (1995), they investigated the relative importance of Basic EPS and Cash flow per share in explaining share prices.

South African shares listed between 1980 and 1999 (20 years) were selected. Sixty three companies remained listed over this period. Linear regressions were firstly estimated to test the relationship between Basic EPS and share prices. Linear regressions were then estimated to test the relationship between share prices and Cash flow per share.

The share prices used were the closing prices on the last day of trading of the particular company's financial year. The EPS numbers were those actually reported by the companies. The numerator used in the calculation of Cash flow per share was the "cash flows from operating activities" less dividends paid to preference shareholders and minorities. The denominator used for Cash flow per share was the same as for Basic EPS.

De Villiers et al found that both Basic EPS and Cash flow per share had an effect on share prices. However the study found that Basic EPS had a higher correlation with share prices than Cash flow per share.

De Villiers et al concluded that Basic EPS has more explanatory power on share prices than Cash flow per share confirming that the analysis of EPS is economically meaningful, despite the criticisms brought against accounting profits (2003:124). The De Villiers et al study showed that earnings based measures are more economically meaningful than cash flow measures.

3.3 Use of EPS in financial analysis

Lev (1989) states that earnings are believed to be "the premier information item provided in financial statements", that analysts frequently express their perceptions in terms of earnings and that management decisions and compensation are often stated in terms of earnings (Lev 1989:155).

Hemus (1994) states that EPS is a "widely used ratio by most user groups, in particular financial analysts and financial press" (Hemus 1994). David Damant, a former chairman of the FASB, was quoted as saying that "EPS is the most widely used statistic in financial analysis" (Beresford 1997:14).

Even though EPS may be the most used ratio in financial analysis, the ASB's primary objective in revising FRS 3 was to remove any reliance on a single figure to measure company's earnings. The ASB maintains that as long as all the relevant information is available in the "accounts, how analysts choose to interpret the figures is entirely up to them" (Accountancy 1993:14). This sentiment is stated clearly in UKSIP 1 where investors are encouraged not to rely on any one measure of profitability but rather consider a range of information and measures in their analyses.

By surveying the attitudes of a certain category of users, Suliman (2000) studied the extent to which the various EPS measures are used in financial analysis. The user group surveyed were unit trust managers and evidence was obtained on the usefulness of various measures of performance.

Postal opinion research was used for purposes of the Suliman (2000) study with customised questionnaires being sent to 106 equity unit trust managers. The unit trusts were selected from the 1999 Unit Trust Handbook. Twenty eight responses were received. Relevant findings of the Suliman (2000) study are presented.

Suliman (2000) asked the fund managers which factors they considered when investing or disinvesting in shares. The results to this question, as presented in Appendix A of her study (p 111), are presented in table 3.2.

The results show that a company's financial performance is the most important factor when making investment decisions with 25 of the 28 respondents indicating that they "always" considered financial performance when investing. Sentiment (e.g. empowerment shares) and instinct are also used with some frequency. Public opinion is usually not a factor.

Table 3.2: Suliman (2000) study - Factors considered when trading in shares

	1 Always		2 Almost Always		3 Sometimes		4 Seldom		5 Never		Mean	Rank
	no	%	no	%	no	%	no	%	no	%		
Financial performance	25	89	3	11	0	0	0	0	0	0	4.89	1
Sentiment (e.g. empowerment shares)	6	21	5	18	14	50	2	7	1	4	3.46	2
Instinct	4	14	7	25	13	46	3	11	1	4	3.36	3
Public opinion	2	7	1	4	7	25	9	32	9	32	2.21	4

Source: Suliman (2000:111).

Suliman also asked the fund managers to rank the various EPS measures in terms of their usefulness in financial statement analysis (ranking them from 1 to 5, 1 being most useful and 5 being least useful). The results, as presented in Appendix A (p 122) of her study, are presented in table 3.3.

The results show that the fund managers consider Headline EPS to be the most useful EPS measure with a high degree (mean of 4.4 out of 5) of usefulness attached to it. Diluted EPS is considered to be more useful than Basic EPS and Cash flow per share.

Little usefulness is attached to Basic EPS and Dividends per share. Due to the Basic EPS weaknesses discussed in Chapter 2, it is not surprising that Basic EPS has a low usefulness ranking.

Table 3.3: Suliman (2000) study - Usefulness of EPS measures

	1		2		3		4		5			
	Rank 1		Rank 2		Rank 3		Rank 4		Rank 5		Mean	Rank
	no	%	no	%	no	%	no	%	no	%		
Basic EPS	2	7	2	7	3	11	10	36	11	39	2.07	4
Diluted EPS	7	25	9	32	6	22	4	14	2	7	3.54	2
Headline EPS	18	64	4	14	5	18	1	4	0	0	4.4	1
Cash flows per share	1	4	10	36	8	28	8	28	1	4	3.04	3
Dividends per share	0	0	3	11	6	21	5	18	14	50	1.93	5

Source: Suliman (2000:122).

Based on the results of her survey, Suliman (2000) showed that financial performance (earnings) of a company is the most significant consideration when making buy or sell decisions on capital markets. Also, of the various EPS measures, Headline EPS is the measure considered most useful by institutional investors. This finding is consistent with the Hemus and Mildenhall (1995) study which showed that a measure similar to Headline EPS was most correlated with share prices.

With regards to Diluted EPS, the findings of Suliman (2000) support the findings of Balsam and Roland (1998). Balsam and Roland (1998) showed that there is a greater correlation between Diluted EPS and share prices than there is between Basic EPS and share prices (Balsam and Roland 1998:247). Suliman (2000) showed that users consider Diluted EPS as having more information content than Basic EPS.

The results of the Suliman (2000) study also show that institutional investors prefer earnings based measures (Headline and Diluted) to cash flow based measures. This supports the finding of De Villiers et al (2003) who showed that Basic EPS was more correlated with share prices than Cash flow per share. This finding is significant as earnings based measures are often criticised with many commentators suggesting that Cash flow per share is a better measure than the earnings based measures.

3.4 Susceptibility of earnings to manipulation

As mentioned earlier, various commentators believe that companies manipulate their results. Childs (1971) states that companies give out misinformation to manipulate security prices. He believes that annual reports seek to glorify management's accomplishments, while hiding its failings (Childs 1971:123).

He goes on to explain that public companies have an obligation to provide conditions under which investors can buy and sell shares at fair market prices. As share prices are established on the basis of available information, company management should endeavour to report earnings that will correctly represent the company's earnings power. He says that the reporting of true earnings results in a fairer market price for a company's shares (Childs 1971:122).

Hemus and Tindall (1993) encourage investors to be weary of reported financial information as it is "often tainted with creativity" (Hemus and Tindall 1993:25). They state that there are two primary factors which contribute to creative accounting:

1. The complexity of the business environment. This they believe has heightened the need for judgement and estimation to be exercised in company reporting.
2. Pressures on management to produce better results. They state company management earnestly attempt to better represent poor performance within a defined set of guidelines (Hemus and Tindall 1993:25).

Thomas (2002) also encourages investors not to be "hoodwinked" by creative company reporting (Thomas 2002:56). He also states that investors should not rely on a single performance measure. He quotes "plunging ratings of growth rate superstars and high profile bankruptcies" as examples of reported EPS numbers not being a fair representation of reality (Thomas 2002:56).

Spacek (1972) cites an example of how two companies with identical operations and reporting structures can report widely differing EPS figures. By altering certain accounting policies of these two companies (for example, the treatment of research costs and the valuation of inventory) he was able to calculate a range of possible EPS figures for them, ranging from $0.06 to $1,79 (Spacek 1972:643).

Thomson (1995) in his article in Management Today stated that in order to maintain a show of growth and profits, companies become increasingly creative with their accounting (Thomson 1995:56). SAICA also believes that companies seek to manipulate earnings as they state that companies work around accounting standards to achieve desired results (SAICA 2003b).

The above points made by the various commentators and regulatory authorities rightfully raise concerns over the fairness of reported financial information. Accordingly, investors must use judgement and consider a range of information in their decision making. Quantitative and qualitative factors should be considered.

3.5 Cash flow per share

Due to the susceptibility of earnings to manipulation various commentators share the view that Cash flow per share is a more reliable measure of how a company has performed over the year.

Commenting on Investopedia.com, an investment and education web site, Rick Wayman, a leading financial analyst in the US, says that "the evaluation of EPS should be a relatively straight forward process, but thanks to the magic of accounting, it has become a game of smoke and mirrors" (Wayman Investopedia.com).

Wayman says that Cash flow per share is a better measure of "earnings" than EPS. He also believes that Cash flow per share is more difficult to manipulate than accounting earnings. He states that a company may show large accounting profits but may have negative cash flows. He believes that companies that show negative cash flows over a period of time will have to eventually borrow money to keep operating. This he believes is a warning sign for corporate failure.

Wayman believes that if operating Cash flow per share (operating cash flow divided by the number of shares used to calculate Basic EPS) is greater than reported EPS, earnings are of a high quality because the company is generating more cash than is reported in the income statement.

If operating Cash flow per share is less than reported EPS, it means that the company is generating less cash than is represented by reported EPS. In this case, EPS is of low quality because it does not reflect the negative operating results of the company and overstates the true (cash) operating results.

In conclusion Wayman states that "cash is king on Wall Street, and companies that generate a growing stream of operating Cash flow per share are better investments than companies that post increased GAAP EPS growth and negative operating Cash flow per share" (Wayman Investopedia.com).

Belamant and De Klerk (2002) also believe that Cash flow per share is a better measure than the earnings based measures. In their article in the Financial Mail they state that "careful study of cash-flow statements has become a vital aspect of analysis, particularly in the wake of bankruptcies stemming from poor cash-flow management" http://free.financialmail.co.za/report/itrankings2002/ itrankc.htm.

They also state that differing accounting polices can significantly affect a companies reported earnings. They quote the period over which a company depreciates fixed assets and the treatment of software and development costs as examples. As cash flows cannot be manipulated by different accounting treatments they believe that Cash flow per share is superior to EPS.

Thomson (1995) in his article "Who needs earnings" in Management Today argued that creative accounting has made Cash flow per share a better measure of performance than EPS. He states that "The beauty of cash flow is that you can't hide (manipulate) it. It's like air in a balloon, you know if it's going in or coming out" (Thomson 1995:57).

Respondents to the Suliman (2000) survey gave the following reasons for their support for the disclosure of Cash flow per share:

- it shows whether the company is generating any cash,
- cash flows are crucial for analysis purposes,

- it is a leading indicator for forthcoming problems because liquidity problems are usually the forerunner of bigger financial problems,
- it indicates the operational efficiency of a company,
- it is useful in the analysis of information technology companies and conglomerates where traditional valuation approaches are difficult to use,
- it is important to assess the quality or earnings because earnings are of no use if the company cannot generate cash flow, and
- cash flows cannot be manipulated by accounting policies, unlike EPS (Suliman 2000:91-92).

However not all commentators believe that Cash flow per share is superior to EPS. Tony Habgood, the CEO of Bunzl Ltd in the UK, supports earnings based per share measures ahead of Cash flow per share. He stated that his company was measured on whether or not they were at a premium to their sector of the stock market, and that required an EPS comparison. He states that "The problem with cash flows is that you cannot use it to compare one company with another easily. EPS gives an easily identifiable measure to everyone" (Thomson 1995:58).

Echoing a similar sentiment was a leading investment analyst in the UK who stated that his clients were uncomfortable with cash flow analysis. He stated that "you have to talk to investors in a language everyone understands" and that investors understand EPS (Thomson 1995:59).

Another problem with Cash flow per share is that not all companies disclose it and those who do may have different bases for calculating the numerator.

Despite the perceptions of Wayman (Investopedia.com), Balmant and De Klerk (2002) and Thomson (1995), the studies of Suliman (2000) and De Villiers et al (2003) have clearly shown that earnings based measures are more useful than cash based measures and that earnings based per share measures have more explanatory power on share prices than cash based per share measures.

3.6 Headline EPS

Green (1992) states that the measure of profit regarded as most useful is "maintainable earnings" as it gives the best indication of future operating performance (Green 1992: 23). David Damant, the Chairman of the IIMR sub-committee on "Headline earnings" stated that, at first the word "maintainable" did indicate the underlying principle involved in the development of Headline earnings (Damant 1993b:75). The IIMR eventually concluded that "maintainable earnings" could not be put on a standardised basis.

David Damant is also a former Chairman of the United Kingdom, European and International Analysts Organisations, and former member of the IASB. As he was also the Chairman of the IIMR sub-committee that developed Headline EPS, he has written extensively on Headline EPS.

On the release of SIP 1 in the UK, Damant (1993b) wrote that Headline earnings as defined was inferior to "maintainable earnings" as a basis for forecasts but nevertheless it was robust and factual. He stated that Headline EPS is justified by its "practical usefulness" even if it cannot encapsulate the company's performance in itself (Damant 1993b:97).

The term "Headline" earnings was selected to "emphasise that there is always some small print to read and bear in mind" (Damant 1993b:97).

After the issue of SIP 1 in the UK, the Financial Times in the UK took the decision to use Headline EPS rather Basic EPS in the calculation of published price earnings ratios (Damant 1993b:97).

Approximately 10 years after UKSIP 1 was issued, David Damant was recently in SA (2003) and commented on the issue of Circular 7/2002. He maintains that the original formula for Headline EPS is still relevant and remains a good measure of company performance from trading activities. He explained that the split between trading and capital items is intuitive and understood by investors. He also highlighted that Headline earnings was developed, in the UK and in SA, in conjunction with financial analysts and fund managers (SAICA 2003b). As such Headline EPS meets the requirements of both preparers and users of annual reports.

There is an assumed link between the earnings number and the valuation of a company. However Damant states that the value of a company depends on the surplus wealth created and this includes gains and losses on trading and capital items (Damant 2002:3). As Headline EPS is a measure of trading performance, it cannot in itself, be a measure of value. He believes that "comprehensive income" is a better measure of value. Comprehensive income is the change in net assets over the period.

As mentioned in chapter two, based on the concept of comprehensive income, the IASB is currently working on a new income statement format.

3.7 Presentation and disclosure

Two previous studies were found relating to the presentation and disclosure of EPS in annual reports. Holgate and Kirby (1994) surveyed annual reports in the UK to see how companies were dealing with the adoption of the revised FRS 3. Hattingh (1999a) reviewed listed company reports in SA to check on their disclosure of Headline EPS.

3.7.1 Holgate and Kirby – 1994

3.7.1.1 Motivation for the survey

Approximately 2 years after FRS 3 became effective in the UK, Holgate and Kirby surveyed the annual reports of the UK's top 100 listed companies to investigate whether or not they were complying with FRS 3. They also investigated how many companies had followed UKSIP's recommendation to disclose Headline EPS.

3.7.1.2 Survey results

The results of the survey showed that none of the 100 companies selected disclosed an extra-ordinary item. Rather items previously classified as extra- ordinary were classified as "exceptional" with seventy one companies (71%) disclosing exceptional items (Holgate and Kirby 1994:142).

As FRS 3 allowed for the disclosure of additional EPS measures, it was found that 54 companies (54%) disclosed an additional EPS measure. Surprisingly only 16 of the 54 companies (16%) disclosed the recommended Headline EPS. The "remainder evidently preferred to tell their own story" (Holgate and Kirby 1994:142).

An investigation was then conducted to determine whether the 38 companies who disclosed an additional non-headline EPS did so to a show a measure of EPS higher than the required EPS number. No definite pattern was found i.e. some companies' additional EPS was lower than the required EPS.

3.7.1.3 Research conclusions

The narrowed definition of extra-ordinary items brought about by the revised FRS 3 had succeeded in preventing companies manipulating results by disclosing loss items as extra-ordinary. Even though UKSIP 1 encouraged the disclosure of Headline EPS, most companies in the UK had opted not to disclose Headline EPS. Finally the study concluded that companies show additional EPS measures "primarily to stabilise their earnings figures and not merely to enhance their reported performance" (Holgate and Kirby 1994:143).

3.7.2 Hattingh – 1999a

3.7.2.1 Motivation for the survey

AC 306 recommended listed companies to disclose Headline EPS. In 1999 Hattingh conducted a survey of 20 listed company reports to investigate whether companies were correctly calculating and disclosing Headline EPS.

3.7.2.2 Survey results

The results of the survey are summarised as follows:

1. He found that 16 (80%) of the companies selected disclosed Headline EPS.
2. Of those 16, only one did not show a reconciliation between Basic and Headline earnings.
3. Of those 16, 12 (75%) contravened AC 306 i.e. had adjusted for items in the calculation of Headline earnings that were not permitted by AC 306.
4. Seven companies (44%) had incorrectly reversed "restructuring costs' incurred in the calculation of Headline earnings (Hattingh 1999a: 25).

Regarding "restructuring costs", Hattingh states that AC 306 para. {f}allows for the reversal of a "provision" for restructuring costs. The objective of this, as stated in AC 306 {f}, is to charge the item in the year in which it occurs. Actual restructuring costs incurred is not a reversible item (Hattingh 1999b:33).

3.7.2.3 Research conclusions

The Hattingh (1995a) study showed that not all South African companies disclose Headline EPS. The study also showed that the majority (75%) of companies disclosing Headline EPS, had contravened the Headline earnings definition.

3.8 Summary

Empirical investigations into EPS reporting, such as Hemus and Mildenhall (1994) and Hattingh (1999a), have revealed that companies are "creative" with their accounting and disclosures. Therefore it is no surprise that earnings and EPS are perceived to have data imperfections with criticisms levied against accounting earnings by commentators such as Childs (1971), Hemus and Tindall (1993), Thomson (1995) and Thomas (2000), Wayman (Investopedia.com) and Belamant and De Klerk (2002).

However despite these perceived data imperfections, studies such as Demsetz (1995), Balsam and Roland (1998), Suliman (2000) and De Villiers et al (2003) have clearly shown that EPS information is very meaningful and important.

Regarding a "best" measure of company performance, commentators and regulatory bodies agree that company performance depends on a range of information and cannot be encapsulated in a single figure.

The following chapters empirically investigate EPS disclosures in SA and provide further insight on the issues which have been discussed in this chapter.

CHAPTER FOUR
METHODOLGY

4.1 Introduction

The previous chapter examined research studies which have been carried out in South Africa and certain overseas countries on those issues of EPS reporting which are of relevance to this study.

This study's research objectives were stated in chapter one. The research objectives are addressed by empirical investigations. This chapter describes the methodology used in conducting the empirical investigations.

The literature review conducted in chapter three revealed that an annual report survey into the Basic, Diluted, Headline and voluntary EPS disclosure practices of South African companies has not previously been done. The literature review also revealed that no empirical investigations have been conducted into the EPS attitudes of preparers of annual reports.

4.2 Research design

The research method was designed to obtain sufficient information to draw conclusions. There are various ways of classifying the design of a research study. One way of classifying research design is to consider the case versus statistical study as presented by Cooper and Emory (1995). They state that the

> "statistical study differs from the case study in several ways. Statistical studies are designed for breadth rather than depth. They attempt to capture a population's characteristics by making inferences from a sample's characteristics. Hypotheses are tested quantitatively. Generalizations about findings are presented based on the representativeness of the sample and the validity of the design.
>
> Case studies place more emphasis on a full contextual analysis of fewer events or conditions and their interrelations. Although hypotheses are often used, the

reliance on qualitative data makes support or rejection more difficult" (Cooper and Emory 1995:116).

As this study seeks to obtain data about/from a large number of companies and to make inferences based on sample findings, the statistical study method is most appropriate for purposes of this study.

4.3 Data collection techniques

Information can be classified into primary and secondary types. Primary data come from original sources and are collected especially to answer the research problem. Secondary data is data obtained from studies carried out by other persons for their own purposes. Primary data can be obtained by means of survey or observation (Cooper and Emory 1995:240).

Surveys are more economical than observations. Surveying allows broad geographic coverage "at a fraction of the cost and time required by observation" (Cooper and Emory 1995:269). Also, information about perceptions can almost always be obtained be means of questioning. As such the survey method of gathering data is considered most appropriate for this study.

In answering the research problem of this study, two separate surveys are conducted:

i. a Financial Statement survey of EPS reporting practice and
ii. a survey of company management's EPS perceptions.

4.4 Financial Statement survey

4.4.1 Survey objective

The Financial Statement survey analyzes the EPS disclosures of selected South African companies, as reported in their annual reports. Companies' EPS disclosures are analyzed on the basis of the relevant accounting pronouncements in order to determine whether or not South African companies are correctly calculating and disclosing the various EPS measures.

4.4.2 Population definition

As EPS information is required of listed companies only, companies listed on the JSE comprised the target group. The Financial Mail publishes an annual list of South Africa's Top 100 industrial companies, ranked by total assets. Companies making up this Top 100, in the 2000 year, were selected as the population. Larger companies' shares are more widely held than smaller companies' shares. As such their EPS disclosures attract greater attention and impact more users than the EPS disclosures of smaller less known companies. The selected companies are listed in Appendix A.

4.4.3 Annual reports

A decision had to be made on which year's annual report, after 2000, would be used. Companies' 2002 reports were selected for inspection, as this was the latest reporting year at the time of conducting the financial statement survey. Annual reports were obtained from the following sources:

i. The School of Accounting and Finance at the University of Natal – Durban,
ii. The Centre for Accountancy at the University of Natal – Pietermaritzburg,
iii. The internet, off selected companies websites, and
iv. Mcgregor Bureau For Financial Analysis

In almost all cases, 2002 reports were used. For companies which delisted or were suspended subsequent to being a Top 100 company of 2000, their latest available annual report was inspected. Both current year and prior year EPS information were analyzed.

4.4.4 Disclosure checklist

To facilitate the financial statement review, a disclosure checklist had to developed. As the essence of this survey was on company compliance with relevant disclosure requirements, the disclosure requirements of the relevant pronouncements were used as the basis for drawing up the checklist.

4.4.5 Testing of the checklist

The checklist was reviewed by the research supervisor. No improvements were suggested. After reviewing approximately 10 annual reports, it became apparent that the checklist had to be modified to take into account differing treatments and observations. A final checklist was then formulated. This is found in Appendix B.

4.4.6 Data analysis

Company compliance or non-compliance with disclosure requirement was captured using spreadsheet software. On completion of the annual report survey, survey results were compiled and tabulated. These results are presented in chapter five.

4.5 Survey of company managements' EPS perceptions

4.5.1 Survey objective

This survey seeks to gather evidence from the preparers as to their attitudes towards EPS. This survey addresses the following research objectives:

- i To determine how important the EPS measures are in comparison to other measures of performance,
- ii To determine which EPS measure is most important,
- iii To provide insight into Headline EPS by discussing whether company management:
  - a) consider Headline earnings to be a measure of sustainable earnings,
  - b) agree with the Headline earnings definition,
  - c) believe that Headline EPS is manipulated,
  - d) support continued disclosure of Headline EPS in SA, and
  - e) consider guidance on Headline EPS to be sufficient.

4.5.2 Data collection method

Three data collections methods can be used for surveys into the perceptions of a population:

- i. personal interviews,
- ii. telephone interviews and
- iii. a mail survey.

The first two modes of data collection are considered impractical for this study because:

- i. the objective of this part of the study is to obtain widespread data from a large number of companies, and

ii. as the person who would have to be interviewed is a high ranking individual in the company organisational structure, it would be difficult to gain access to him/her. They also normally have busy schedules.

Cooper and Emory (1995:282-283) state that the main concern in a mail survey, is non-response. To overcome the risk of non-response, this study used established techniques such as:

i. "easy to understand" questionnaires,
ii. non-lengthy questionnaires,
iii. use of a covering letter,
iv. follow up mailing, and
v. the inclusion of a reply paid envelope.

4.5.3 Population definition

The population selected for this survey was the same population used in the Financial Statement survey i.e. the Financial Mail's Top 100 industrial companies of 2000. This was done to facilitate comparisons between the results of both surveys.

4.5.4 Questionnaire design

A copy of the covering letter and questionnaire is included in Appendix C and D respectively. The covering letter was printed on a University of Natal letterhead implying the approval of the study by the University. It was felt that affiliation with a well known university would encourage companies to respond.

As Financial Directors of listed companies are busy people who are often away on company business, as opposed to being at the company head office, the covering letter was addressed to the Financial Managers of the selected companies. By doing this, a higher response rate was expected.

As EPS reporting is a sensitive area, the covering letter guaranteed the anonymity of all respondents. To motivate companies to respond, the covering letter immediately drew the readers' attention to the fact that completion of the questionnaire would not take long.

The questionnaire was designed so that respondents would merely have to check the appropriate box in answering questions. It was felt that this would simplify the answering process and encourage companies to respond. Certain questions did prompt respondents for reasons for their answer, but these were kept to a minimum.

4.5.5 Testing of questionnaires

The questionnaire was tested by academics at the University of Natal. As these persons are familiar with EPS reporting, they were considered as being able to provide constructive criticism as to the questionnaire design, structure and content.

Several improvements were recommended. These were implemented where considered appropriate.

4.5.6 Mailing

In March 2001, the covering letter and final questionnaire were mailed to each of the selected companies. The first mailing yielded 28 responses. Two months after the first mailing, a follow up mailing was done with questionnaires sent to companies who had not yet responded. The second mailing yielded 16 more responses.

4.5.7 Response rate

The total response rate achieved was 44 (44%). The acceptable minimum number of responses that would allow generalisations to be made about the entire population differs from study to study. Emory states that a response rate of about 30% is usually considered satisfactory (1976:283). As such the response rate of 44% of this study is considered acceptable.

4.5.8 Data analysis

The data gathered from the mailed questionnaires was analyzed quantitatively. Firstly, close ended questions were analyzed using spreadsheet software. This allowed results to be tabulated and for interesting and non-consistent answers to be highlighted. Secondly, responses to open ended questions were analyzed individually and then in conjunction with the responses of other respondents to highlight any interesting and common answers. The results of this survey are presented in chapter six.

4.6 Summary

This chapter explained the methodology used in answering the research problem. It was established that two surveys would be conducted:

iii. A Financial Statement survey of EPS reporting practice and

iv. A survey of company management's EPS perceptions.

The results of the above surveys are presented and evaluated in the following two chapters.

CHAPTER FIVE

PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENT SURVEY RESULTS

5.1 Introduction

The objective in this chapter is to present the findings of the survey of annual reports to determine current reporting practice in South Africa in EPS. The EPS reporting framework and disclosure requirements, as discussed in chapter two, were used as the terms of reference in conducting the survey. Wherever possible, the findings of this survey are contrasted to the findings of the surveys mentioned in chapter three.

The only other South African financial statement survey found on EPS was the Hattingh (1999a) survey where he surveyed the Headline EPS disclosures of 20 companies. The survey conducted as part of this study is more comprehensive as it examines the annual reports of South Africa's top 100 industrial companies of 2000 and analyses their disclosures of Basic, Diluted, Headline and voluntary EPS measures.

It was mentioned in chapter four that in almost all cases where possible 2002 reports were used in conducting the survey. The survey results are presented below. For purposes of presenting the survey results, the year of the annual report (most cases 2002) is referred to as the "current year" and the comparative year (most cases 2001) is referred to as the "prior year.

5.2 Basic EPS

5.2.1 Basic EPS survey results

The disclosure requirements and survey results relating to Basic EPS are presented in table 5.1. The results show that all the selected companies disclosed Basic EPS for the current reporting period as well as the comparative year. All companies present Basic EPS on the face of the income statement, in compliance with AC 104.48.

Even though AC 104.50 requires companies to disclose the numerator (Basic earnings) in the EPS note, only 74 (74%) companies did this. A recalculation of Basic EPS for the other 26 companies revealed that these companies had correctly used "profit attributable to ordinary shareholders" as the numerator.

Table 5.1: Basic EPS					
	Ref	**Current Year**		**Prior Year**	
	AC	No	%	No	%
Disclosed	104.48	100	100%	100	100%
On face of income statement	104.48	100	100%	100	100%
Numerator					
Disclosed in the EPS note	104.50	74	74%	74	74%
Not disclosed in the EPS note but equal to profit attributable to ordinary shareholders		26	26%	26	26%
		100	100%	100	100%
Denominator					
Disclosed in the EPS note	104.50	97	97%	97	97%
Instances of more than one class of ordinary share		0		0	

Companies are much better with their disclosure of the denominator as 97 (97%) companies disclosed the weighted average number of shares in the EPS note. Other EPS disclosures (Diluted and Headline) making up the EPS note for the three companies who did not disclose the denominator were scrutinized to see if the Basic EPS denominator could be ascertained from them. One company disclosed the number of shares used in the calculation of Headline EPS and a recalculation of Basic EPS for this company confirmed that this was the denominator used for Basic EPS.

The share capital note of the other two companies was then inspected to see if the number of shares could be determined from there. This revealed that, as these two companies did not have a movement in their share capital account for the current year, the number of shares disclosed in share capital note had to be the Basic EPS denominator for the current year. A recalculation of their Basic EPS confirmed this for both the current and prior years.

It was interesting to find that none of the companies surveyed had more than one class of ordinary share. This indicates that companies have simplified their capital structures over the years.

5.2.2 Summary on Basic EPS disclosures

The survey revealed good disclosure of Basic EPS by most South African companies. The only really disappointing finding was that 26% of the selected companies did not disclose the numerator in the EPS note. These companies as well as the three companies not disclosing the denominator, contravened the disclosure requirements of AC 104.

5.3 Diluted EPS

5.3.1 Diluted EPS survey results

The disclosure requirements and survey results of Diluted EPS, as shown in table 5.2, indicate that 66 companies disclosed Diluted EPS. It would appear that the other 34 companies did not have dilutive instruments. Even though it would be good disclosure, AC 104 does not specify that companies need to disclose Diluted EPS even if it is equal to Basic EPS.

However 5 of the 66 companies disclosed Diluted EPS even though they did not have any dilutive instruments i.e. their Basic EPS was equal to their Diluted EPS. Even though AC 104.48 requires Diluted EPS to be disclosed on the face of the income statement, with equal prominence to Basic EPS, four companies disclosed Diluted EPS in the EPS note.

A careful reading of AC 104.50 reveals that companies are required to disclose the Diluted EPS numerator even if it is equal to the Basic EPS numerator. However only half (current year 52%; prior year 50%) of the affected companies disclosed the Diluted EPS numerator in the EPS note. A recalculation of Diluted EPS for the other companies revealed that the numerator was Basic earnings.

Even though 61 companies had dilutive instruments, only 13 (prior year 17) of these companies had differing Basic and Diluted EPS numerators. This is not surprising as a review of companies' dilutive instruments revealed that most companies had outstanding share options rather than convertible securities.

Table 5.2: Diluted EPS

	Ref AC	Current Year No	Current Year %	Prior Year No	Prior Year %
Disclosed		**66**	66%	**66**	66%
Disclosed on the face of the income statement	104.48	62	94%	62	94%
Disclosed in the EPS note		4	6%	4	6%
		66	100%	66	100%
Numerator					
Disclosed in the EPS note	104.50	34	52%	33	50%
Not disclosed in the EPS note but equal to Basic earnings		32	48%	33	50%
		66	100%	66	100%
Reconciliation of numerator					
Instances where Diluted earnings was not equal to Basic earnings		**13**	**20%**	17	26%
Reconciliation disclosed	104.50	6	46%	7	41%
Reconciliation not disclosed		7	54%	10	59%
		13	100%	17	100%
Denominator					
Disclosed in the EPS note	104.50	63	95%	59	89%
Not disclosed in the EPS note		3	5%	7	11%
		66	100%	66	100%
Reconciliation of denominator					
Not applicable as Diluted EPS equal to Basic EPS		**5**		5	
Reconciliation disclosed	104.50	38	62%	37	61%
Reconciliation not disclosed		23	38%	24	39%
		61	100%	61	100%

Outstanding share options ordinarily result only in an adjustment to the Diluted EPS denominator, as only the "not for value" portion is adjusted for.

Where companies have differing Basic and Diluted EPS numerators, AC 104.50 requires that these two be reconciled back to each other or that Diluted earnings be reconciled back to "net profit/loss for the period". Less than half (current year 46%; prior year 41%) of the affected companies disclosed the required reconciliation. The companies who did disclose the numerator reconciliation, all reconciled Diluted earnings to Basic earnings rather than to "net profit/loss for the period".

Regarding the Diluted EPS denominator, even though most companies (current year 95%; prior year 89%) disclosed this, some companies (current year 5%; prior year 11%) did not disclose the denominator as required by AC 104.50.

As mentioned five companies disclosed Diluted EPS even though it was equal to Basic EPS for both years presented. As such denominator reconciliations were expected for all 61 other companies disclosing Diluted EPS. However approximately a third (current year 38%; prior year 39%) of these companies failed to disclose the required denominator reconciliation.

5.3.2 Summary on Diluted EPS disclosures

The survey identified the following significant contraventions of AC 104:

i. some companies (6%) disclosed Diluted EPS in the notes rather that on the face of the income statement,

ii. approximately half of the affected companies failed to disclose the numerator used,

iii. reconciliations between Basic and Diluted earnings were only provided 46% (prior year 41%) of the time that one was required, and

iv. thirty eight percent (prior year 39%) of the affected companies failed to disclose the reconciliation between the number of shares used in the calculation of Basic and Diluted EPS.

The above contraventions indicate that company disclosure of Diluted EPS in South Africa is poor with many companies contravening the Diluted EPS disclosure requirements of AC 104.

5.4 Headline EPS

Survey results are first presented on the number of companies disclosing Headline EPS and their compliance with the disclosure requirements of AC 306. Thereafter survey results on companies' compliance with the Headline earnings definition are presented.

5.4.1 Headline EPS disclosures

5.4.1.1 Number of companies disclosing Headline EPS

Survey results on the number of companies disclosing Headline EPS are presented in table 5.3.

Table 5.3: Number of companies disclosing Headline EPS

	Ref	Current Year		Prior Year	
	AC	No	%	No	%
Headline EPS disclosed	306.15	93	93%	93	93%
Companies disclosing Diluted Headline EPS rather than (Basic) Headline EPS		2	2%	2	2%
Overall disclosure rate		95	95%	95	95%

The results show that almost all (93%) of the selected companies disclosed (Basic) Headline EPS as recommended by AC 306 and as required by the JSE listing requirements.

Possible reasons for the other seven companies not disclosing Headline EPS were investigated. It was found that three companies reported in terms of another country's GAAP with two companies reporting in terms of US GAAP and one company reporting in terms of UK GAAP. The company reporting in terms of UK GAAP has a dual listing as it is also listed on the London Stock Exchange.

Holgate and Kirby (1994) found that most UK companies surveyed were not following the recommendation in SIP 1 to disclose Headline EPS. Rather companies were disclosing other voluntary EPS measures instead (Holgate and Kirby 1994:142). As such it was decided to check whether the three companies reporting in terms UK or US GAAP had disclosed another voluntary EPS measure.

The company reporting in terms of UK GAAP disclosed "EPS before exceptional items". One of the companies reporting in terms of US GAAP disclosed "EPS from continuing operations". These two other EPS measures are different from Headline EPS and are discussed at 5.5.4 and 5.5.3 respectively. The other company reporting in terms of US GAAP only disclosed Basic and Diluted EPS.

As these three companies report in terms of another country's GAAP, AC 306 does not apply to them. As such it cannot be said that they have contravened AC 306. However as these companies are listed on the JSE, they have contravened the JSE listing requirements. This also applies to the company with a dual listing as the fact that it is listed on another exchange does not exclude it from complying with the JSE listing requirements.

A check was then done on the remaining four companies to see if they had disclosed another EPS measure in place of Headline EPS. The results of this investigation are as follows:

- one company did not disclose any other measure in place of Headline EPS,
- two companies disclosed "Diluted Headline EPS", and
- one company disclosed "EPS before exceptional items".

Neither the JSE listing requirements nor AC 306 mention "Diluted" Headline EPS. Even though it is generally accepted that they refer to an undiluted or "basic" measure, it is the author's view that the two companies who disclosed Diluted Headline EPS instead of (Basic) Headline EPS have not contravened the JSE listing requirements as those companies would have based the calculation of the numerator on the Headline earnings definition. The Suliman (2000) study also showed that dilutive measures are much more useful than undiluted or basic measures.

Adding the two companies who disclosed Diluted Headline EPS instead of (basic) Headline EPS to the number of companies disclosing Headline EPS, results in an overall survey rate of 95 (95%) companies. Hattingh (1999a) found that 80% of the companies he surveyed disclosed Headline EPS (Hattingh 1999a:25). If this is compared to the 95% overall disclosure rate of this survey, it is evident that more companies are now disclosing Headline EPS.

5.4.1.2 Company compliance with AC 306 disclosure requirements

Table 5.4 presents the survey results as to companies' compliance with the disclosure requirements of AC 306.

Table 5.4: Compliance with Headline EPS disclosure requirements

	Ref AC	Current Year No	Current Year %	Prior Year No	Prior Year %
Headline EPS disclosed	306.15	**95**	95%	**95**	95%
On the face of the income statement		94	99%	94	99%
In the EPS note		1	1%	1	1%
		95	100%	95	100%
Headline earnings reconciliation					
Not applicable as Headline earnings equal to Basic earnings		**6**	**6%**	7	8%
Reconciliation disclosed		89	100%	88	100%
Reconciliation not disclosed		0	-	0	-
		89	100%	88	100%
Reconciliation to show:					
Nature,	306.15	89	100%	88	100%
Amount,	306.15	89	100%	88	100%
Tax effects, and	306 apx	34	38%	34	39%
Effects on minority shareholders	306 apx	21	24%	21	24%
Discussion, commentary and analysis of main features underlying the calculation of Headline EPS	306.15	0	-	0	-
Instances where Headline earnings reconciliation was disclosed on the face of the income statement		**12**	13%	12	14%
Denominator					
Denominator disclosed	306 apx	56	58%	56	58%
Denominator not disclosed but equal to Basic EPS denominator		39	42%	39	42%
		95	100%	95	100%

apx = appendix to AC 306

Even though AC 306 does not specify that Headline EPS must be disclosed on the face of the income statement, almost all (99%) of the companies disclosing Headline EPS, disclose it on the face of the income statement.

Companies are very good with their disclosure of the Headline earnings reconciliation as 100% of the companies with differing Basic and Headline EPS numbers, disclosed the required reconciliation between Basic and Headline earnings. This finding corroborates the Hattingh (1999a) survey as he found that all but one of the companies had disclosed the Headline earnings reconciliation (Hattingh 1999a:25). Whilst Hattingh (1999a) did not provide evidence as to whether companies had disclosed the nature and amount of each reconciling item, this current survey found that all companies also disclosed the nature and amount of each reconciling item as required by AC 306.15.

The illustrative example appendixed to AC 306 shows the tax and outsiders effects of reconciling items as well. This is considered good disclosure and by virtue of the fact that it is disclosed in the illustrative example appendixed to AC 306, it is also interpreted as being recommended disclosure. However only 38% (prior year 39%) of the affected companies disclosed the tax effects of adjustments while 24% showed the effects on outsiders. However, as these have been interpreted as recommended disclosure only, it cannot be said that the companies who failed to disclose these effects have contravened AC 306.

AC 306.15 states that "management is also encouraged to provide in the financial statements an objective discussion, commentary and analysis of the main features underlying the calculation of Headline earnings per share". None of the companies gave this disclosure. As this is also only recommended disclosure, the companies have not contravened AC 306 here.

Twelve companies disclosed their Headline earnings reconciliation on the same page as the income statement, below the conclusion of the normal income statement. This gives an indication as to the significance that certain companies attach to Headline earnings.

Even though the disclosure requirements of AC 306 do not state that the denominator must be disclosed, the denominator is disclosed in the illustrative example appendixed to AC 306. This is considered good disclosure. However only 58% of the affected companies disclosed the denominator used in the calculation of Headline EPS.

5.4.1.3 Summary on Headline EPS disclosures

Almost all (95%) of the selected companies disclosed Headline EPS. Two of these companies disclosed the diluted version instead of the basic one. The five companies who did not disclose Headline EPS contravened the JSE listing requirements.

Companies did very well with their disclosure of the reconciliation between Basic and Headline earnings as all (100%) the affected companies disclosed the required reconciliation. However AC 306's recommended disclosures were not followed by most companies.

5.4.2 Headline EPS adjustments

This section first presents the results on the surveyed frequency of allowed Headline adjustments. Thereafter the results on surveyed disallowed Headline adjustments are presented.

5.4.2.1 Allowed Headline adjustments

The headline adjustments allowed by AC 306 and Circular 7/2002 together with their surveyed frequency are shown in table 5.5.

The survey results show that the most common Headline adjustments are profits or losses relating to property, plant and equipment and adjustments relating to goodwill. This is not surprising as profit or losses relating to fixed assets are common occurrences in most businesses. The high frequency rate relating to goodwill is also not surprising as AC 131- Business Combinations (SAICA 1999), requires goodwill to be amortized.

Profit and losses arising from discontinuance and investments also have a relatively high frequency. Company restructuring results in many companies discontinuing divisions or operations in an attempt to cut costs and/or focus on core or profitable divisions. As such the relatively high frequency of profits or losses from the discontinuance of these operations is not surprising. Also as most companies hold investment portfolios, profits or losses from their disposal or fair value adjustment is expected.

Table 5.5: Allowed Headline adjustments

	ref AC	Current Year No	Current Year %	Prior Year No	Prior Year %
Companies having adjusting items		89		88	
Allowed Adjustments					
Profit or loss from the sale or discontinuance of an operation, division or business	306.11(b)	29	33%	35	40%
Profit or loss from the sale or variation of an interest in subsidiary, joint venture or associate	306.11(c)	14	16%	15	17%
Profit or loss from the sale of or change in fair value of investments	306.11(c)	29	33%	20	23%
Profit or loss from the sale of or change in fair value of property, plant and equipment	306.11(c)	63	71%	57	65%
Profit or loss from the reorganisation or redemption of long term debt	306.11(d)	2	2%	2	2%
Provisions relating to:					
Profit or loss on sale or discontinuance of an operation, division or business	306.11(f)	0	-	1	1%
Restructuring and reorganisation costs	306.11(f)	5	6%	1	1%
Profit or loss on sale of property, plant and Equipment	306.11(f)	0	-	0	-
Amortization of and changes in fair value of Goodwill	306.11(g)	54	61%	42	48%
Extra-ordinary items	306.11(l)	2	2%	1	1%
Fair value adjustments to intangible assets other than goodwill	Circ 7/2002.5	2	2%	2	2%
Employee benefits transitional provision relating to a change from a benefit to contribution plan	Circ 7/2002.6	3	3%	1	1%
Total allowed adjustments		203		177	

The survey results show that allowed adjustments relating to provisions are not as frequent as they may have been prior to the issue of AC 130- Provisions, Contingent Liabilities and Contingent Assets (SAICA 1999). The low frequency of adjustments relating to the redemption or reorganisation of debt and extra-ordinary items was expected as these events or transactions do not occur often in practice.

Two of the three instances of extra-ordinary items related to gains or losses arsing from fire damage and the other related to losses caused by flooding to a South African company's subsidiary in Mozambique. Evidently the intention the standard setters had when they amended the definition of "extra-ordinary items" appears to have been successful.

The low incidence of extra-ordinary items as found by this survey supports the Holgate and Kirby (1994) survey. Holgate and Kirby found no "extra-ordinary items" in the 1993 annual reports of the UK's top 100 companies (Holgate and Kirby 1994:142). Holgate and Kirby concluded that the standard setters had been successful in preventing company abuse of extra-ordinary items.

The low incidence of adjustments relating to fair value changes on intangible assets other than goodwill and the employee benefit transitional provision probably result from the fact that these additional adjustments were only sanctioned in Circular 7/2002 which was issued in December 2002. It is expected that more companies will make these Headline adjustments in future years.

5.4.2.2 Disallowed Headline EPS adjustments

Surveyed adjustments found that are not allowed by AC 306 or Circular 7/2002 are presented in table 5.6. Disallowed adjustments that increased Headline earnings are separated from disallowed adjustments that decreased Headline earnings.

Table 5.6: Disallowed Headline adjustments

	Current Year		Prior Year	
	No	%	No	%
Number of companies having adjusting items	**89**		**88**	
Adjustments that increased Headline earnings				
Restructuring and reorganisation costs	23	26%	24	27%
Debenture interest	4	5%	2	2%
Bid costs written off	3	3%	1	1%
Other	3	3%	3	3%
Retrenchment costs–not related to discontinuance	2	2%	1	1%
Amortization of intangibles	2	2%	2	2%
Merger costs	2	2%	2	2%
Pre-opening expenditure of a new division	2	2%	1	1%
Restraint of trade payment	1	1%	2	2%
Acquisition costs of new company	1	1%	1	1%
Cancellation of share option scheme	1	1%	-	-
Deconsolidation of a subsidiary	1	1%	1	1%
Payment for early lease cancellation	1	1%	1	1%
Early settlement costs of debt portion of convertible debentures	1	1%	-	1%
Loss on conversion of debentures	1	1%	1	1%
Onerous contract costs	1	1%	-	-
Post retirement medical expenses	1	1%	-	-
Premium paid on acquisition of shares from outsiders	1	1%	1	1%
Share repurchase expenses	1	1%	-	-
Unbundling expenses	1	1%	-	-
Regulatory increase in provisions	1	1%	1	1%
Head lease and property provisions	1	1%	-	-
Provision for retrenchments costs	1	1%	1	1%
Provision for pension fund closure costs	1	1%	-	-
Provision for impairment of loan	1	1%	2	1%
Long term provision for environmental remediation	1	1%	-	-
Provision for future net rental expenditure on onerous contracts	1	1%	-	-
Provision for possible patent infringement	-	-	1	1%
	60		48	
Adjustments that decreased Headline earnings				
Reversal of general provision	3	2%	2	1%
Reversal of warranty provision	2	2%	-	-
Other	2		2	
Release of provision no longer required	1	2%	-	-
Capital profits – no details	1	1%	1	1%
Capital receipt – no details	1	1%	-	-
Compensation for cancellation of exclusive distributions rights	-	-	1	1%
Demutualization share proceeds received	-	-	1	1%
Liquidation dividend received	1	1%	1	1%
Profit on disposal of option on building	1	1%	-	-
Profit on sale of lease option	-	-	1	1%
Realised surplus on listing of subsidiary	1	1%	-	-
Underwriting commission received	1	1%	-	-
	14		9	
Total disallowed adjustments	74		57	

Before discussing the disallowed adjustments found, it is necessary to build a frame of reference against which these disallowed adjustments can be judged.

As mentioned in chapter two, the characteristics on which the Headline earnings definition was developed are:

- it had to be a measure of trading performance separated from capital (non trading) items,
- it had to be robust, and
- it had to be factual.

Based on these characteristics, the IIMR formulated the Headline earnings definition.

UKSIP 1, AC 306 and Circular 7/2002 are all clear in their presentation of the definition of Headline earnings in that they all give a very finite definition of Headline earnings. They do this by specifically stating in each paragraph making up the definition what the allowed Headline adjustments are. It was the intention of the standard setters to leave no room for interpretation. If an item is not one of the mentioned adjustments or if it cannot be categorized as one of the mentioned adjustments, it would be a contravention of the Headline earnings definition.

The standard setters made this clear in specifying that the measure had to be robust. This was interpreted by UKSIP as meaning that anyone presented with the building blocks should be able to calculate Headline earnings. It is for this reason that Headline EPS is commonly referred to as an "unambiguous reference point".

It would appear that the main objectives in specifying a robust measure were to improve comparability among companies and to ensure that companies could not arbitrarily make their own Headline adjustments. It would also appear that the standard setters had considered it probable that companies would abuse the Headline earnings definition if given the opportunity to do. The abuse by companies of "extra-ordinary items", prior to its revised definition, is a case in point.

Based on the above discussion and the disallowed adjustments presented in table 5.6, it is concluded that certain South African companies are contravening the definition of

Headline earnings. This finding is corroborated by Hattingh (1999a). Hattingh found that the 75% of the companies who had disclosed Headline EPS, had contravened the Headline earnings definition (Hattingh 1999a:25).

This survey found that the most common disallowed Headline adjustment was restructuring costs with 26% (prior year 27%) of the affected companies adjusting for it. Hattingh (1999a) also found that companies were incorrectly adjusting for actual restructuring costs incurred and not the allowed provision for restructuring costs.

However Hattingh found that a higher percentage (44%) of companies had adjusted for restructuring costs (Hattingh 1999a:25). Hattingh did not mention disallowed adjustments found other than "restructuring costs". Thus it can be assumed that restructuring costs were also the most common disallowed adjustment found by him.

The relatively high number of companies adjusting for restructuring costs, as found by both this and the Hattingh surveys, may indicate confusion among companies as far as this adjustment is concerned. Addressing the issue of possible confusion among companies as far as restructuring costs are concerned, it is necessary to look to the accounting pronouncement in question.

AC 306.11 {f} clearly states that provisions in respect of restructuring or reorganisation costs should be reversed "so that expenses are charged in the year in which they occur". As this guidance appears clear, it is difficult to understand why companies may be confused. Whilst it is possible that there may be genuine confusion over this adjustment, the possibility that companies may be intentionally misinterpreting the relevant sub-paragraph in AC 306, cannot be ruled out.

In presenting his results, Hattingh also stated that the actual restructuring cost is not an adjusting item (Hattingh 1999b:33). The fact that his survey results were published in the widely distributed Accountancy SA magazine, may be the reason for the reduction in the number of companies adjusting for actual restructuring costs.

The second most common disallowed adjustment found was debenture interest with four companies (prior year two) adjusting for it. Debenture interest is a normal financing cost and all financing costs are part of Headline earnings.

It should be noted that "bid cost written off" relates to bid costs incurred in acquiring another company. "Retrenchment costs" did not relate to a discontinued division as this would then have been an allowed adjustment (Circular 7/2002.1).

A few companies had classified an item/s as "other" in their Headline earnings reconciliation. As evident from table 5.6 "other" resulted in increases and decreases to Headline earnings. When the rand value of "other" was compared to "net profit/loss for the period", it was found that "other" was immaterial (less than 2% of net profit/loss for the period) for all the affected companies. It is possible that "other" consisted of allowed Headline adjustments that were immaterial to mention individually. It should be noted that almost all selected companies report in millions.

Even though disclosing "other" is not necessarily good disclosure, it cannot be concluded that they are disallowed adjustments. As such this category of adjustment will be excluded from all further analyses.

The low frequency of the remaining adjustments indicates a lack of support by companies as to these items. Even if any of these other disallowed adjustments had support, the fact that they are not mentioned in AC 306 or Circular 7/2002 would still make them a contravention of the relevant statements.

Table 5.7 presents an overall summary on surveyed Headline EPS adjustments. Table 5.7 shows that approximately one in four (current year 27%, prior year 24%) of the total adjustments made were contraventions of AC 306. This is a significant proportion of disallowed adjustments.

Table 5.7: Headline adjustments summary

	Current Year No	Current Year %	Prior Year No	Prior Year %
Total adjustments				
Total allowed adjustments made	203	75%	177	77%
Total disallowed adjustments made – excl. "other"	69	25%	52	23%
	272	100%	229	100%
Disallowed adjustments made				
That increased Headline earnings	57	83%	45	87%
That decreased Headline earnings	12	17%	7	13%
	69	100%	52	100%
Companies				
Companies that made only allowed adjustments	45	51%	51	58%
Companies that made disallowed adjustments as well	44	49%	37	42%
	89	100%	88	100%
Companies making **disallowed** adjustments				
Companies making disallowed adjustments that only increased Headline earnings	33	75%	29	78%
Companies making disallowed adjustments that only decreased Headline earnings	0	-	4	11%
Companies making disallowed adjustments that increased and decreased Headline earnings	11	25%	4	11%
	44	100%	37	100%
Companies making **disallowed** adjustments:				
1 disallowed adjustment	27	61%	26	70%
2 disallowed adjustments	12	27%	8	22%
3 disallowed adjustments	3	8%	2	5%
4 disallowed adjustments	1	**2%**	1	3%
5 disallowed adjustments	1	2%	0	-
	44	100%	37	100%

As the overwhelming majority (current year 83%, prior year 87%) of disallowed adjustments increased companies' Headline earnings, it appears that companies who do abuse the Headline earnings definition, do so in order to overstate their Headline earnings.

To give a proper perspective, the disallowed adjustments were then analysed in terms of companies making disallowed adjustments and companies only making allowed adjustments. Table 5.7 shows that of the 89 (prior year 88) affected companies, half (49%) in current year and 42% in the prior year contravened the Headline earnings definition.

Hattingh found that a much higher percentage (75%) of the companies disclosing Headline EPS, had contravened the Headline EPS definition (Hattingh 1999a:25).

There appears to be a discrepancy between the findings of this survey and the Hattingh (1999a) survey as Hattingh found a greater proportion (75%) of the affected companies had contravened AC 306. However as Hattingh only analysed 20 company reports, it is possible that the discrepancy may be due to a sampling error.

Table 5.7 also shows that 75% (33 companies) of the companies making disallowed adjustments, made disallowed adjustments that increased their Headline EPS. The corresponding figure for the comparative year is higher at 78 % (29 companies).

Some companies (current year 25%, prior 11%) do however make disallowed adjustments that increase and decrease Headline earnings. In the prior year it was also found that four (11%) companies had made disallowed adjustments that only decreased Headline earnings. Based on the information presented, it cannot be said that these companies contravened the Headline earnings definition in order to overstate their Headline earnings.

However, from the results shown in table 5.7, it can be concluded that approximately one in three (current year 33 companies, prior year 29 companies) of all selected companies overstated their Headline earnings by making disallowed Headline adjustments.

The disallowed adjustments were then analysed in terms of the number of adjustments made by each affected company. Table 5.7 also shows that the majority (current year 88%, prior year 92%) of companies making disallowed adjustments had made either one or two disallowed adjustments.

5.4.2.3 Summary on Headline EPS adjustments

Surveyed results relating to the 89 (prior year 88) companies having Headline adjustments are summarized below.

- Approximately one in four (current year 25%, prior year 23%) of all adjustments made were a contravention of the Headline earnings definition.
- Approximately half (current year 49%, prior year 42%) of the affected companies contravened the Headline earnings definition.

- This resulted in the vast majority of these companies (current year 75%, prior year 78%) overstating their Headline EPS.
- A few companies (current year 25%, prior year 6%) who had contravened the Headline earnings definition, made disallowed adjustments that increased and decreased Headline earnings.
- In the prior year, four companies (11%) (current year Nil) companies who had contravened the Headline earnings definition, made adjustments that only decreased Headline earnings.

It can be concluded that a significant number of South African companies contravened the Headline earnings definition. Most companies who contravened the Headline EPS definition disclosed overstated Headline EPS numbers as a result. It was also shown that one third of all selected companies overstated their Headline EPS.

5.5 Voluntary EPS disclosures

Prior to presenting the survey results relating to voluntary EPS measures, it is necessary to mention AC 104's requirements relating to voluntary EPS measures. Where an enterprise discloses other EPS measures, AC 104 gives the following guidance:

- The denominator used must be the same that is used for calculating Basic EPS and
- Where the numerator used is not a line item in the income statement, a reconciliation must be disclosed between the numerator used and a line item in the income statement (AC 104:52).

Surveyed voluntary EPS disclosures found, with a frequency of more than one, are presented in Table 5.8.

Table 5.8: Voluntary EPS disclosures found	**No.**	**%**
Diluted Headline EPS	44	44%
Cash equivalent EPS	9	9%
Attributable cash flow per share	6	6%
Headline EPS from continuing operation	7	7%
EPS before exceptional items	4	4%

Table 5.8 shows that Diluted Headline EPS was the most common voluntary EPS disclosure, with approximately half (44) of the companies disclosing it. Each of these measures is separately discussed below.

5.5.1 Diluted Headline EPS

Surveyed results specific to Diluted Headline EPS are presented in table 5.9.

There is no specific requirement for companies to disclose a diluted version of Headline EPS. However 42 of the 44 companies disclosed Diluted Headline EPS in addition to the undiluted version. The relatively high number of companies voluntarily disclosing Diluted Headline EPS in addition to (basic) Headline EPS, may indicate that these companies concede that diluted measures are more useful than undiluted measures.

Ninety three percent of the companies disclosing Diluted Headline EPS, disclosed it on the face of the income statement. Even though AC 104 does not state that the numerator used for voluntary EPS disclosures must be disclosed in the EPS note, it is implied that this would have to be disclosed. Twenty five (57%) of the companies did not disclose the numerator used.

Where a company does not have dilutive convertible debentures or preference shares available, then Headline earnings is ordinarily the same as Diluted Headline earnings. In such instances, the reconciliation required by AC 104.52 is not necessary. This was the case for 75% of the companies disclosing Diluted Headline EPS. Three of the companies (27%) who should have reconciled Diluted Headline earnings to Headline earnings, failed to do so. These companies contravened AC 104.52.

AC 104.52 does not expressly say that the denominator used for voluntary EPS disclosures needs to be disclosed in the EPS note. It does however require the denominator to be the same as the Basic EPS denominator. However this is not possible for Diluted Headline EPS, as Diluted Headline EPS requires the Basic number of shares to be adjusted for potential dilutions.

Table 5.9: Diluted Headline EPS	Ref AC	No.	%
Disclosed on the face of the income statement		41	93%
Disclosed in the EPS note		3	7%
		44	100%
Numerator			
Equal to Headline earnings and disclosed in the EPS note		8	18%
Equal to Headline earnings but not disclosed in the EPS note		25	57%
Not equal to Headline earnings but disclosed in the EPS note		11	25%
		44	100%
Reconciliation of numerator			
Reconciliation not required as Diluted Headline earnings equal to Headline earnings		33	75%
Reconciliation required as Diluted Headline earnings not equal to Headline earnings	104.52	11	25%
		44	100%
Where reconciliation required:	104.52		
Reconciliation disclosed		8	73%
Reconciliation not disclosed		3	27%
		11	100%
Denominator	104.52		
Denominator disclosed in the EPS note		23	52%
Denominator not disclosed but equal to number of share as for Diluted/Basic EPS		21	48%
		44	100%

Thirty-nine (89%) of the 44 companies who disclosed Diluted Headline EPS, also disclosed Diluted EPS. Approximately half (52%) of the companies disclosing Diluted Headline EPS disclosed the denominator used in the EPS note.

For the companies who did not disclose the denominator, a check was done to see if the correct denominator was used. It was found that these companies used the correct denominator i.e. if they had disclosed Diluted EPS, the diluted number of shares was used, otherwise the basic number of shares was used. Even though these companies did not disclose the denominator used, it cannot be said that they contravened AC 104.52.

5.5.2 Cash flow measures

Only two cash flow EPS measures were found. They are "Cash equivalent EPS" and "Attributable cash flow per share". Two companies have different terminology for "Cash equivalent EPS" calling it "Attributable cash equivalent EPS". All companies uniformly use "Attributable cash flow per share" for the purely cash flow measure. One company disclosed Headline cash equivalent EPS instead of (basic) Cash equivalent EPS.

Table 5.8 shows that Cash equivalent EPS (9%) had a higher frequency than Attributable cash flow per share (6%). It was interesting to find that all six companies who disclosed Attributable cash flow per share also disclosed Cash equivalent EPS. As such three companies only disclosed one cash flow measure which was Cash equivalent EPS.

From the survey results it can be deduced that only 9% of the selected companies disclosed a cash flow EPS measure. Even though chapter three showed growing support for cash flow per share measures, the majority (91%) of selected companies only presented earnings based per share measures.

This study does show how the cash flow measures have been calculated by the affected companies. This provides a guideline for calculating the cash flow measures where they are not disclosed.

5.5.2.1 Cash equivalent EPS

Cash equivalent EPS survey results are presented in table 5.10.

More companies (five companies out of nine) disclosed Cash equivalent EPS in the notes rather than on the face of the income statement (four companies out of nine). Companies presenting Cash equivalent EPS were all very good with their disclosure of the reconciliation between Basic/Headline earnings and Cash equivalent earnings. All nine companies used the correct denominator i.e. the Basic EPS denominator. However only six companies disclosed the denominator used.

	Ref AC	No	%
Disclosure			
Disclosed on the face of the income statement		4	44%
Disclosed in the EPS note		5	56%
		9	100%
Numerator			
Disclosed in the EPS note		9	100%
Reconciliation provided between Basic earnings and cash equivalent earnings	104.52	9	100%
Denominator	104.52		
Disclosed in the EPS note		6	67%
Denominator not disclosed but equal to number of share as for Basic EPS calculation		3	33%
		9	100%

Cash equivalent reconciliation

Companies	1	2	3	4	5	6	7	8	9
Basic/Headline earnings	✔	✔	✔	✔	✔	✔	✔	✔	✔
Adjustments for non cash items:									
Amortization of intangibles	✔		✔			✔			
Deferred tax	✔	✔	✔	✔	✔	✔	✔	✔	
Depreciation	✔	✔	✔		✔	✔			✔
Impairment losses			✔						
Other non-cash flow items	✔		✔	✔	✔	✔	✔	✔	
Profit/loss on sale of assets		✔							✔
Share of associates earnings	✔			✔	✔				✔
Minorities share of non cash items			✔		✔			✔	
Cash equivalent earnings	X	X	X	X	X	X	X	X	X

Items making up the affected companies numerator reconciliation are also presented in table 5.10. The reconciliations show that all companies start with Basic/Headline earnings. Except for working capital changes, all non-cash flow items affecting Basic earnings are then adjusted for. It is apparent from the reconciliation summary in table 5.10 that some companies mention the non-cash flow items individually whereas some companies group some of these non-cash flow items together. However the items making up the reconciliation can be accepted as a general format for calculating the Cash equivalent EPS numerator.

5.5.2.2 Attributable cash flow per share

Survey results relating to Attributable cash flow per share are presented in table 5.11.

Table 5.11: Attributable cash flow per share

	Ref AC	No.	%
Disclosure			
Disclosed on the face of the income statement		1	17%
Disclosed in the EPS note		5	83%
		6	100%
Numerator			
Disclosed in the EPS note		6	100%
Reconciliation provided between cash flows from operating activities and attributable cash flow	104.52	6	100%
Denominator			
Disclosed in the EPS note	104.52	4	67%
Denominator not disclosed but equal to number of share as for Basic EPS calculation		2	33%
		6	100%

Attributable cash flow reconciliation

Companies	1	2	3	4	5	6
Cash flow from operating activities	✔	✔	✔	✔	✔	✔
Adjustments						
Minority interests		✔	✔	✔		✔
Preference dividend paid						✔
Attributable cash flow	X	X	X	X	X	X

Only one of the six companies disclosed Attributable cash flow per share on the face of the income statement. However all six companies disclosed the required numerator reconciliation. A reconciliation between the numerator used and Basic earnings or a line item in the income statement, as required by AC 104.52, is usually not done for Attributable cash flow per share.

The reason for this is that a reconciliation between "cash flows from operating activities" and "net profit/loss for the period" is usually done as part of the Cash Flow Statement. This was the case for all six affected companies. This cannot be construed as a contravention of AC 104.52. Whilst all six companies used the correct denominator, only four had mentioned the actual number of shares used.

Regarding the numerator, table 5.11 also shows the reconciliation items of the six affected companies. Companies used "cash flows from operating activities" per the Cash Flow Statement as the starting point with adjustments made for outsiders' interests and preference dividends paid. This gives cash flows available to ordinary shareholders. This can be accepted as the format for calculating the Attributable cash flow per share numerator.

5.5.2.3 Company motivation for disclosing cash flow EPS measures

As only a few companies (nine) disclosed a cash flow EPS measure/s, the reasons why these companies had decided to disclose these measures were investigated. Were they just giving good disclosure or was there another beneficial reason? As such it was decided to investigate whether the companies who disclosed the cash flow measures did so to enhance the disclosure of their trading performance.

Each cash flow measure was compared to Basic and Headline EPS. The objective in doing the comparisons was to establish whether a pattern exists among the companies disclosing cash flow measures i.e. did company's cash flow EPS exceed their Basic and Headline EPS? The results of these comparisons are presented in tables 5.12 and 5.13.

<u>Cash equivalent EPS compared to Basic and Headline EPS</u>

The results to this investigation are presented in table 5.12.

Table 5.12: Cash equivalent EPS versus Basic EPS and Headline EPS

	Current year		**Prior year**	
	No	%	No	%
Disclosed	**9**		**9**	
Cash equivalent EPS was greater than Basic EPS	9	100%	9	100%
Cash equivalent EPS was less than Basic EPS	-		-	
	9	100%	9	100%
Cash equivalent EPS was greater than Headline EPS	**8**	**89%**	**8**	89%
Cash equivalent EPS was less than Headline EPS	1	11%	1	11%
	9	100%	9	100%

The results show a clear and definite pattern in that all affected (100%) companies' current year Cash equivalent EPS numbers were greater than their respective Basic EPS measures. When Cash equivalent EPS was compared to Headline EPS in the current year, it was found that all but one of the affected companies had higher Cash equivalent EPS than Headline EPS.

The statistics were the same for the prior year. In the current and prior years, the same company had a lower Cash equivalent EPS number than Headline EPS. From this it can be concluded that eight (89%) of the nine companies disclosed a higher Cash equivalent EPS than Basic and Headline EPS in the current and prior years.

Based on these results it may appear reasonable to conclude that companies voluntarily disclose Cash equivalent EPS because it shows a healthier situation than Basic and Headline EPS. However this needs to be carefully considered. If one looks at the cash equivalent reconciliation shown in table 5.10, it is evident that all but one of the reconciling items are expense items, with "profit on sale of assets" as the only income item.

As most of the reconciling items are expense items, it may be assumed that these items would result in a higher Cash equivalent EPS than Basic EPS. This is not an unfair assumption as a company's "profit on sale of assets" would usually not be large enough to offset its current depreciation charge, let alone the other reconciling expense items. As such it would be expected that a company's Cash equivalent EPS would be higher than its Basic EPS. This was the case in both the current and prior years, for all companies disclosing Cash equivalent EPS.

While it can be assumed that Cash equivalent EPS will be higher than Basic EPS, a similar generalization cannot be made about Cash equivalent EPS and Headline EPS. Whether or not Cash equivalent EPS would be greater than Headline EPS would depend on the net rand value of the Headline reconciling items compared to the net rand value of the Cash equivalent reconciling items. As such Cash equivalent EPS may be higher or lower than Headline EPS.

The above discussion has shown that Cash equivalent EPS can be expected to be higher than Basic EPS. This was the case for all affected companies in this survey. A question that arises is why don't other companies disclose Cash equivalent EPS? A possible answer is that Cash equivalent EPS may be less than Headline EPS.

Table 5.12 does show that Cash equivalent EPS for eight of the nine companies disclosing it was higher than their Headline EPS. This may be the reason why these companies disclosed Cash equivalent EPS. As such it can be concluded that by disclosing Cash equivalent EPS, almost all companies enhanced the disclosure of their trading performance.

Attributable cash flow per share compared to Basic and Headline EPS

The results to this investigation are presented in Table 5.13.

Table 5.13: Attributable cash flow per share versus Basic EPS and Headline EPS

	Current year		Prior year	
	No	%	No	%
Disclosed	**6**		**6**	
Attributable cash flow per share was greater than Basis EPS	4	67%	5	83%
Attributable cash flow per share was less than Basic EPS	2	33%	1	17%
	6	100%	6	100%
Attributable cash flow per share was greater than Headline EPS	4	67%	5	83%
Attributable cash flow per share was less than Headline EPS	2	33%	1	17%
	6	100%	6	100%

Table 5.13 shows that four (67%) of the affected companies in the current year and five (83%) in the prior year, had a higher Attributable cash flow per share than Basic and Headline EPS. As such the results also show a pattern among companies disclosing Attributable cash flow per share.

It is not possible to predict a relationship between Attributable cash flow per share and Basic EPS, as was the case with Cash equivalent EPS and Basic EPS. This is due to the fact that companies have differing working capital requirements. All things being equal, a company with more money tied up in debtors and inventory, would have a lower Attributable cash flow per share than Basic EPS, and vice versa. As with Cash equivalent EPS, a relationship cannot be established between Attributable cash flow per share and Headline EPS.

However table 5.13 does show that the majority of companies that disclosed Attributable cash flow per share, enhanced the disclosure of their reporting performance as a result. This may be the reason why these companies disclosed Attributable cash flow per share.

5.5.2.4 Summary on cash flow EPS measures

Cash flow measures are not as common as expected with only nine companies disclosing a cash flow measure. Cash equivalent EPS was more common than Attributable cash flow per share. An investigation into companies' motivation for disclosing a cash flow measure revealed that the cash flow measure/s of most companies were higher than their respective Basic and Headline EPS numbers. This may indicate that these companies disclosed cash flow EPS measures to enhance the disclosure of their trading performance.

It was also found that companies did well with their disclosure of cash flow EPS as all companies disclosed the required numerator reconciliation.

5.5.3 Headline EPS from continuing operations

Headline EPS share from continuing operations is similar to Headline EPS. Whilst the Headline earnings definition excludes the profit or loss on the actual discontinuance of a division or operation, the profit or loss earned from the discontinued operation/s are specifically included in the Headline earnings definition (AC 306.11{b}).

Headline EPS from continuing operations uses the Headline earnings definition to calculate the numerator with one additional adjustment. The profit or loss derived from the discontinued operation are also excluded. By excluding this non-recurring item, businesses show Headline earnings from continuing operations.

Survey results relating to Headline EPS from continuing operations are presented in table 5.14.

Five of the six companies disclosed Headline EPS from continuing operations in addition to Headline EPS. One company referred to EPS from continuing operations as "Pro forma Headline EPS" and another company called it "Headline EPS excluding discontinued operations". The company which did not disclose Headline EPS called the measure in question (basic) "EPS from continuing operations".

Table 5.14: EPS from continuing operations	No.	%
Disclosed – on the face of the income statement	**6**	
Numerator		
Disclosed in the EPS note	6	100%
Numerator reconciliation		
Reconciliation disclosed	4	67%
Reconciliation not disclosed	2	33%
	6	100%
Denominator		
Disclosed in the EPS note	3	50%
Not disclosed but equal to Basic EPS denominator	3	50%
	6	100%

All six companies disclosed "EPS from continuing operations" on the face of the income statement. Regarding the numerator reconciliation, it was found that only four companies showed the numerator reconciliation required by AC 104.52. These four companies reconciled Basic\Headline earnings to Basic\Headline earnings from continuing operations. The two companies who failed to disclose the numerator reconciliation, contravened AC 104.52.

Even though all companies used the correct denominator, only three of the six companies disclosed the actual number shares used in the calculation.

5.5.4 EPS before exceptional items

This is a measure of a company's earnings before all items it classifies as exceptional. There is no guidance as to what a company can classify as exceptional and the exceptional items of companies were found to include Headline and non-headline adjusting items. The survey results relating to "EPS before exceptional items" are presented in table 5.15.

Two of the four companies disclosed EPS before exceptional items in addition to Headline EPS. All four companies disclosed EPS before exceptional items on the face of the income statement.

Table 5.15: EPS before exceptional items	No.	%
Disclosed – on the face of the income statement	4	
Numerator		
Disclosed in the EPS note	4	100%
Numerator reconciliation		
Reconciliation disclosed	3	75%
Reconciliation not disclosed	1	25%
	4	100%
Denominator		
Disclosed in the EPS note	3	75%
Not disclosed but equal to Basic EPS denominator	1	25%
	4	100%

Regarding the numerator, all four companies disclosed the numerator in the EPS note. However only three did a reconciliation between Basic earnings and "earnings before exceptional items". The other company contravened the disclosure requirement of AC 104.52.

All companies used the correct denominator. However only three disclosed the actual number of shares used.

5.5.5. Comparison between other EPS measures and Basic and Headline EPS

As with the cash flow measures, it was decided to investigate whether the companies disclosed the additional earnings EPS measures to better reflect their trading performance. The results to this investigation are presented in table 5.16.

The results in table 5.16 indicate no definite pattern. As such it can be concluded that companies do not necessarily disclose other voluntary earnings measures to enhance their trading performance. This finding is corroborated by the Holgate and Kirby (1994) study which found that companies were not disclosing Headline EPS but rather disclosing other voluntary EPS measures instead. They investigated whether the affected companies disclosed voluntary non-headline EPS measures to better reflect their trading performance. They found no definite pattern (Holgate and Kirby 1994:142).

Holgate and Kirby concluded that companies disclose other EPS measures "primarily to stabilise their earnings figures and not merely to enhance their reported performance" (Holgate and Kirby 1994:143). That conclusion can be applied to this study as well.

Table 5.16: Other EPS measures compared with Basic and Headline EPS

	Current year		Prior year	
	No	**%**	**No**	**%**
Headline EPS from continuing operations				
Disclosed	**6**		**6**	
Headline EPS from continuing operations was greater than Basic EPS	4	67%	1	17%
Headline EPS from continuing operations was less than Basic EPS	2	33%	5	83%
	6	100%	6	100%
Headline EPS from continuing operations was greater than Headline EPS	3	50%	1	17%
Headline EPS from continuing operations was less than Headline EPS	1	17%	4	67%
Headline EPS from continuing operations was equal to Headline EPS	1	17%	-	-
Headline EPS was not disclosed	1	16%	1	16%
	6	100%	6	100%
EPS before exceptional items				
Disclosed	**4**		**4**	
EPS before exceptional items was greater than Basic EPS	2	50%	2	50%
EPS before exceptional items was less than Basic EPS	2	50%	2	50%
	4	100%	4	100%
EPS before exceptional items was greater than	1	25%	1	25%
EPS before exceptional items was less than Headline EPS	1	25%	1	25%
Headline EPS not disclosed	2	50%	2	50%
	4	100%	4	100%

5.5.6 Summary on voluntary EPS measures

Diluted Headline EPS was the only voluntary EPS found with a relatively high frequency, with 44% of the selected companies disclosing it. Whilst many believe that cash based measures are better measures of performance than earnings based measures, most companies (91%) did not present Cash flow per share measures. However these measures can be calculated by users.

The study has shown that the companies who disclosed cash flow measures, may have been motivated by the fact that it enhanced the disclosure of their trading performance.

This cannot be said for "Headline EPS from continuing activities" and "EPS before exceptional items" as it was found that companies disclosed these measures to primarily stabilise the disclosure of their Basic EPS rather than enhance their trading performance.

Regarding disclosure requirement compliance, AC 104 is not very clear in setting out the disclosure requirements for voluntary EPS measures. In effect, the only required disclosure requirement is a reconciliation between the numerator used and Basic earnings or a line item in the income statement. This was properly presented by all companies disclosing cash flow EPS measures. However three (27%) companies disclosing Diluted Headline EPS, two (33%) companies disclosing EPS from continuing operations and one (25%) company disclosing EPS before exceptional items failed to provide the required numerator reconciliation. These companies contravened the disclosure requirements of AC 104.52.

5.6 Overall survey summary

Company disclosures relating to Basic EPS were very good. Company disclosures relating to Diluted EPS were poor. Ninety five percent of the selected companies disclosed Headline EPS. Their disclosure of the required reconciliation between Basic and Headline earnings was very good as all companies presented the relevant reconciliation.

However the survey revealed contravention of the Headline earnings definition by half of the selected companies. This abuse resulted in approximately one third of all selected companies overstating their Headline EPS. Users of financial statements should thus exercise caution when using Headline EPS as a performance measurement tool.

CHAPTER SIX
PRESENTATION AND ANALYSIS OF QUESTIONNAIRE RESULTS

6.1 Introduction

This dissertation has so far examined Earnings per share by firstly, discussing the EPS reporting framework, secondly by a literature review and then by a financial statement survey of company EPS practices. This chapter examines the results of a questionnaire sent to preparers of annual reports to survey their attitudes towards EPS disclosures. The questionnaire is shown in Appendix D.

The preparers selected are the Financial Managers of South Africa's Top 100 industrial companies of 2000. These are the Financial Managers of the companies whose EPS disclosures were surveyed in chapter five. The questionnaire objectives, design and response rate was discussed in chapter four. The results of this survey are presented below.

6.2 Respondent profile

The last question in the questionnaire (question 15) sought to gather information as to the experience level of respondents by asking them for their number of years of managerial experience. The results to this question are presented in table 6.1.

Table 6.1: Experience level of respondents

Years of experience	No.	%
Less than 5 years	12	27%
5 – 10 years	14	32%
11 – 20 years	13	30%
More than 20 years	5	11%
	44	100%

Table 6.1 shows that most respondents are fairly experienced with 32 (73%) respondents having more than five years of experience at a management level. As such most respondents are suitably qualified to provide meaningful insight into EPS reporting.

6.3 Importance of accounting measures of performance

Question one of the questionnaire asked respondents to rank the importance of the various accounting measures of performance found in annual reports. These were chosen by examining various annual reports, using in particular the "financial highlights" section shown by most companies. The results of this question are shown in table 6.2.

Table 6.2: Importance of accounting measures of performance found in annual financial statements

	1		2		3		4		5			
	Not at all important		**Minor importance**		**Fairly important**		**Very Important**		**Extremely important**		**Mean**	**Rank**
	no	%	no	%	No	%	no	%	no	%		
Turnover	1	2	3	7	6	14	6	14	28	64	4.30	5
Gross Profit	1	2	2	5	6	14	14	32	21	48	4.18	7
Profit before tax	-	-	-	-	5	11	15	34	24	55	4.43	4
Profit after tax	-	-	2	5	7	16	13	30	22	50	4.25	6
Profit attributable to ordinary shareholders	-	-	1	2	5	11	9	20	29	66	4.50	3
Earnings per share	-	-	-	-	6	14	7	16	31	70	4.57	2
Cash inflow or outflow for the year	-	-	-	-	1	2	14	32	29	66	4.64	1
Net asset value	-	-	6	14	16	36	11	25	11	25	3.61	9
Dividends per share	5	11	5	11	5	11	10	23	19	43	3.75	8

n = 44

According to the ranking obtained by calculating the mean scores in shown in table 6.2, Financial Managers ranked the cash inflow or outflow for the year as the most important accounting measure of performance. EPS was ranked second followed by the more traditional profit measures found in the income statement. Gross profit is not a disclosable item in South Africa which may explain its low ranking. As dividends are a distribution of net profit rather than a component of net profit, it is also not in itself a measure of performance as is net asset value, ranked second last and last respectively.

It is interesting to note that 43 (98%) respondents regard "cash inflow or outflow for the year" as either "extremely important" or "very important". The corresponding figure for EPS is 38 (86%) respondents. Based on the survey results, it can be concluded that management place more emphasis on cash flows than they do on earnings.

6.4 Importance of other financial measures and EPS measures.

Question 2 of the questionnaire asked respondents to rank the importance attached to other financial indicators not ordinarily found in the financial statements as well as the three EPS measures. Responses to this question have been separated and are shown in tables 6.3 and 6.4 below.

6.4.1 Importance of financial measures of performance.

The importance placed by respondents on financial measures not ordinarily found in financial statements, is presented in table 6.3.

Table 6.3: Importance of financial indicators not ordinarily found in annual financial statements

	1 Not at all important		2 Minor importance		3 Fairly important		4 Very important		5 Extremely important		Mean	Rank
	no	%	no	%	no	%	no	%	no	%		
Dividend yield	5	11	8	18	12	27	14	32	5	11	3.14	4
Price-earnings ratio	2	5	2	5	9	20	17	39	14	32	3.89	2
Return on assets	-	-	1	2	10	23	17	39	16	36	4.09	1
Cash flow per share	3	7	4	9	12	27	14	32	11	25	3.59	3
n = 44												

Table 6.3 indicates that the return on assets was the most popular financial indicator followed secondly by the price earnings ratio, and thirdly by Cash flow per share with dividend yield in fourth place.

The reason why management view return on assets as being most important of the other financial measures, probably relates to the fact that return on assets is a ratio that is widely used by analysts and investors. It is also common to find that management is internally evaluated on how well they are utilizing assets.

With a mean of 3.89, the price earnings ratio is also very important. This may be due to the fact that the PE ratio directly impacts the value attached to the company and as such also affects security valuation. As with Dividends per share in table 6.2, dividend yield is ranked last. The Suliman (2000) study also showed that users consider Dividends per share to be the least useful per share statistic (Suliman 2000:122). As such management and users share a similar sentiment on the usefulness/importance of dividend information.

Regarding a cash flow measure, the results in tables 6.2 and 6.3 appear to show a discrepancy. Table 6.2 shows that "cash inflow or outflow for the year" was more important than earnings measures. Table 6.3 shows that Cash flow per share is less important than return on assets, an earnings measure. Also, the mean score of "cash inflow or outflow for the year" in table 6.2 is 4.64 whilst the mean score of "Cash flow per share" in table 6.3 is 3.59. This amounts to a 22% difference in mean scores.

"Cash inflow or outflow for the year" includes cash flows from operating, investing and financing activities, per the Cash Flow Statement. "Cash flow per share" ordinarily only includes cash flows from operating activities. If this is the reason for the large difference in the two mean scores, then it could be implied that management place more emphasis on total net cash flow, than they do on cash flows from operating activities.

It is also probable that since Cash flow per share is not a disclosable item, it is considered less important than net cash flow for the year, which is a disclosable item. Chapter 5 did show that only a few companies in SA disclose Cash flow per share.

A comparison of the responses in tables 6.2 and 6.3 indicates that management view the pure accounting indicators of performance as being of greater importance than the financial indicators not ordinarily found in annual financial statements. This may relate to the fact that the accounting measures (e.g. profit before tax and EPS) of performance are highly correlated with company performance, whereas the financial indicators not ordinarily found in the financial statements are more often only used in making buy or sell decisions.

The results may also be biased as the annual reports produced by the Financial Managers ordinarily exclude the other financial indicators. Investors usually look to financial analysts to provide such information.

6.4.2 Importance of EPS measures

The importance placed by management on the EPS measures is shown in table 6.4.

Table 6.4: Importance of Earnings per share measures

	1 Not at all important		2 Minor importance		3 Fairly important		4 Very important		5 Extremely important		Mean	Rank
	no	%	no	%	no	%	no	%	no	%		
Basic earnings per share	1	2	2	5	15	34	12	27	14	32	3.82	2
Diluted earnings per share	3	7	2	5	16	36	14	32	9	20	3.55	3
Headline earnings per share	1	2	2	5	3	7	7	16	31	70	4.48	1

n= 44

The analysis of responses show that management consider Headline EPS to be the most important EPS measure, followed by Basic EPS and then Diluted EPS. The reason for Headline EPS being the most important EPS measure probably relates to the way it is calculated. Unlike Basic and Diluted EPS, Headline EPS excludes non-trading items and as such is considered a better measure of trading performance.

The high degree of importance attached to Headline EPS also has to do with the emphasis which the market places on it. As mentioned in chapter three, the JSE only captures Headline EPS. Also, announcements of company results in the media often refer to Headline earnings with Headline earnings performance mentioned in the article title.

As mentioned in Chapter 2, Basic and Diluted EPS can be very volatile. Management therefore endeavour to show steady growth in Headline EPS. This is what existing shareholders expect and prospective shareholders are looking for. Studies such as Demsetz (1995), Hemus and Mildenhall (1994), Balsam and Roland (1998), De Villiers et al (2003) have shown significant correlation between share prices and reported EPS numbers. In fact Hemus and Mildenhall (1994) found that a measure similar to Headline EPS was more correlated with share prices than Basic EPS (Hemus and Mildenhall 1994:37).

Table 6.4 also shows that management consider Basic EPS to be more useful than Diluted EPS. It is expected that Diluted EPS would have more information content to investors than preparers. This as well as other EPS comparisons between preparers and users are presented in table 6.5.

Users' EPS perceptions are obtained from the Suliman (2000) study, as discussed in chapter three. Table 6.5 shows the mean EPS importance of preparers as well as the mean EPS usefulness of users. To facilitate comparisons between EPS measures and Cash flow per share, Cash flow per share results are also included in the analysis.

Table 6.5: Comparison between preparers' and users' EPS perceptions

	Preparers		Users	
	Mean	Rank	Mean	Rank
Basic EPS	3.82	2	2.07	4
Diluted EPS	3.55	4	3.54	2
Headline EPS	4.48	1	4.4	1
Cash flow EPS	3.59	3	3.04	3

Table 6.5 shows that both investors and management consider Headline EPS to be the most important/useful EPS measure, both attaching a high degree of importance/usefulness to it. Investors and management also agree on Cash flow per share both ranking it 3rd. As Cash flow per share has been ranked 3rd, it can be concluded that both management and investors consider earnings based per share

measures to be more useful/important than Cash flow per share. This finding corroborates that by De Villiers and et al (2003) who found that EPS was more correlated with share prices than Cash flow per share (De Villiers et al 2003:124).

Management and investors rank Basic and Diluted EPS differently. Management consider Basic EPS to be more important than Diluted EPS while investors consider Diluted EPS to be more useful than Basic EPS. The reasons for this difference probably relate to the contrasting perspectives of preparers and users.

Preparers are concerned with presenting the current periods results, giving little attention to forecasts of future earnings. While investors are also concerned about the current periods results, they are also look to the future and try to predict future EPS. Management probably consider that Diluted EPS gives little indication of future earnings and as such is not very important. This issue is considered later where results are presented on whether preparers consider Diluted EPS to be a measure of future earnings.

As investors are concerned with potential dilutions in their investment, they consider Diluted EPS to be more useful than the preparers do. The reason for the low ranking of Basic EPS by users probably relates to the fact that Basic EPS is an all inclusive measure. Therefore from a financial analysis point of view it cannot be very useful. Balsam and Roland (1998) did show that Diluted EPS was more correlated with share prices than Basic EPS, confirming that users attach greater usefulness to Diluted EPS than they do to Basic EPS (Balsam and Roland 1998:247).

From the above discussions, it may be concluded that Headline EPS is the most important/useful EPS measure to preparers, users and the market. It can also be concluded that EPS measures are more important/useful than Cash flow per share measures.

6.5 Income statement classification

Two questions relating to income statement classification were posed to respondents.

6.5.1 Abnormal items and exceptional items excluded from extra-ordinary items

Question 4 asked respondents whether or not they agreed with the AC 103's 1993 revised definition of extra-ordinary items which excluded "abnormal items" and "exceptional items" from being classified as extra-ordinary items. Results to this question are shown in table 6.6.

Table 6.6: Should abnormal/exceptional items be excluded from the extra-ordinary items definition?

	No	%
Yes	14	32%
No	12	27%
It doesn't matter due to the Headline earnings adjustment	18	41%
	44	100%

Twelve respondents (27%) disagreed with the revised definition and fourteen (32%) respondents agreed with the revised definition. However eighteen respondents (41%) stated that the new definition did not matter due to the fact that most "abnormal" or "exceptional items" are allowed headline adjustments. These results can be interpreted to mean that the majority (73%) of respondents don't mind the new treatment of "abnormal" and "exceptional" items.

6.5.2 Extra-ordinary items included in Basic earnings

Question 3 asked respondents whether or not they agreed with the 1998 revisions to AC 104 which included extra-ordinary items in the definition of Basic earnings. The results to this question are shown in table 6.7.

Table 6.7: Should extra-ordinary items be included in Basic earnings?

	No	%
Yes	14	32%
No	5	11%
It doesn't matter due to the Headline earnings adjustment	25	57%
	44	100%

While 32% of the respondents agreed with the revised definition of Basic earnings, 57% of the respondents conceded that as extra-ordinary items would be adjusted for in the Headline earnings calculation, the revised definition of extra-ordinary items would not make a difference.

Tables 6.6 and 6.7 show that more respondents disagreed with the new treatment of abnormal and exceptional items (27%) than with the new treatment of extra-ordinary items (11%). This is probably due to the fact that some adjustments classified as abnormal or exceptional by companies are not allowed headline adjustments.

6.6 Diluted EPS

Table 6.4 showed that, of the three EPS measures, management considers Diluted EPS to be least important. Two questions were put to the preparers to obtain evidence on management's perceptions relating specifically to Diluted EPS.

6.6.1 Continued disclosure of Diluted EPS

Question 12 asked management whether or not Diluted EPS should continue to be disclosed. The results to this question are presented in table 6.8.

Table 6.8: Should Diluted EPS be disclosed?

	No	%
Yes	33	75%
No	11	25%
	44	100%

Even though preparers ranked Diluted EPS as being the least important EPS measure, table 6.8 shows that the majority (75%) of respondents said "yes" to the continued disclosure of Diluted EPS. Eleven (25%) respondents thought that Diluted EPS should not be a disclosable item.

As mentioned in chapter 2, Diluted EPS does have significant information content for investors as it shows the risk of potential dilution in their investment. Suliman (2000) also showed that users consider Diluted EPS to be more useful than Basic EPS. As the objective of financial reporting is to disclose meaningful (useful) information to users, Diluted EPS should continue to be disclosed.

Question 12 asked respondents to give a reason for their answer. Some of their reasons are stated below.

For respondents who said "yes" to continued disclosure:

i. It provides dilutive information to users,
ii. It is needed to project future EPS,
iii. It is relevant in calculating future PE ratios, and
iv. Share options is a good way for management to hide the "true" number of shares.

For respondents who said 'no" to continued disclosure:

i. Diluted EPS is irrelevant in assessing future performance,
ii. "waste of time" – only relevant if there are a large number of options outstanding,
iii. "Information overload" – with all the EPS calculations, and
iv. Diluted EPS is usually not materially different to Basic EPS,

6.6.2 Diluted EPS as a measure of future earnings

Question 13 asked respondents how strong a measure of future earnings is Diluted EPS? The responses to this question are presented in table 6.9.

Table 6.9: Diluted EPS as an indicator of future earnings

	No	%
Very strong	**2**	5%
Strong	**12**	27%
Not so strong	**21**	41%
No indication whatsoever	9	20%
	44	100%

The most popular response (41%) was that Diluted EPS is not a strong indicator of future earnings. Twenty percent of the respondents stated that Diluted EPS gives no indication of future earnings. This is probably why preparers ranked Diluted EPS as being of relatively low importance in table 6.4.

Diluted EPS in itself cannot be a measure of future earnings. Future earnings depend on a range of information that includes qualitative factors as well. What Diluted EPS does do, is to indicate to shareholders what the potential dilution in their investment is. It should be remembered that Diluted EPS has the same flaws as Basic EPS. Diluted Headline EPS would be a better measure of future earnings than Diluted EPS. However Diluted Headline EPS is also not in itself a measure of future earnings. It is however a good starting point for future projections.

6.7 Headline EPS

Prior to the commencement of this study, it was considered that Headline EPS was a crucial number in the annual report. The results presented in table 6.5 have now confirmed this, showing that preparers and management consider Headline EPS to be the most important/useful EPS measure. This part of the chapter presents findings on managements' perceptions on issues that underlie the calculation and disclosure of Headline EPS.

6.7.1 Headline earnings as a measure of sustainable earnings

Due to the possibility that Headline EPS was being considered a measure of sustainable earnings, it was decided to obtain evidence from preparers on this aspect. Evidence was obtained in two ways. Firstly, question 6 asked respondents whether they thought Headline EPS was a measure of sustainable earnings. Question 7 asked respondents whether, in their opinion, Headline EPS was being perceived as being a measure of sustainable earnings. The results to question 6 are presented in table 6.10.

The survey results show misunderstanding of Headline EPS by most respondents as the majority (73%) of respondents thought that Headline EPS was a measure of sustainable earnings. UKSIP 1 clearly states that Headline EPS is not a measure of sustainable earnings and that sustainable earnings cannot be put on a standardized basis.

Table 6.10: Is Headline EPS a measure of sustainable earnings?		
	No	%
Yes	32	73%
No	12	27%
	44	100%

As mentioned in chapter 2, sustainable earnings requires significant adjustment to reported earnings as well a high degree of estimation and judgment. It would also require all non-recurring items to be removed. Headline earnings includes recurring and non-recurring items. An obvious example of a non-recurring item included in Headline earnings is the profit/loss arising from discontinued operations.

The misunderstanding that preparers have may have been due to lack of proper guidance on Headline EPS. Prior to December 2002, the only South African pronouncement on Headline EPS was AC 306. Unlike Circular 7/2002, AC 306 did not provide commentary on whether or not Headline EPS was a measure of sustainable earnings.

The results to question 7 are presented in table 6.11.

Table 6.11: Is Headline EPS perceived to be a measure of sustainable earnings?		
	No.	%
Yes	40	91%
No	4	9%
	44	100%

Ninety one percent of the respondents stated that Headline EPS was perceived (by investors, press etc) as being a measure of sustainable earnings. As the majority of the preparers themselves thought that Headline EPS was a measure of sustainable earnings, it is reasonable to assume that most users also believe that Headline EPS is a measure of sustainable earnings. Therefore the view shared by 91% of the preparers is probably correct.

It can be assumed that since the issue of Circular 7/2002, more preparers would now know that Headline earnings is not a measure of sustainable earnings. As most users do not usually get to see accounting pronouncements, they probably still incorrectly consider Headline EPS to be a measure of sustainable earnings. Presumably, sophisticated investors would be better informed.

Question 6 asked the respondents to give reasons why they thought Headline EPS was or was not a measure of sustainable earnings. Some of these are stated below. The number of respondents giving the same/similar reason is shown in brackets (where no number is shown, that particular reason was stated by one respondent).

Reasons given by respondents who stated that Headline EPS was a measure of sustainable earnings were:

i. It eliminates significant non-recurring items (11 respondents).
ii. It gives an indication of operating profit adjusted for unusual transactions throughout the year.

Reasons given by respondents who stated that Headline EPS was not a measure of sustainable earnings were:

i. Headline EPS numbers are being manipulated (2 respondents).
ii. Sustainable earnings is more a cash flow than earnings exercise.
iii. There is no way that future sustainability can be assessed from one number.
iv. Sustainability is more a function of cash derived from operating activities than revenue growth.
v. Little about the current year reflects sustainability for future years.
vi. Headline EPS is a history number.
vii. Headline EPS is a good starting point for calculating sustainable earnings.

6.7.2 The Headline earnings definition

Question 8 dealt with the Headline earnings definition. The first part of question 8 listed AC 306's allowed Headline adjustments and asked respondents to tick the adjusting factor/s that they thought should not be an adjusting factor/s. The second part of question 8 asked respondents to suggest other Headline adjustments, not presently allowed. The results to the first part of question 8 are presented in table 6.12.

Table 6.12: AC 306's Headline earnings adjusting factors and whether or not they should be adjusting factors

	Yes	%	no	%
Goodwill amortization	33	75%	11	25%
Profit or loss on sale of assets	26	59%	18	41%
Profit or loss on discontinuance of a division or operation	39	89%	5	11%
Write down of assets/impairment losses	35	80%	9	20%
Provision for profit or loss on termination of an operation.	41	93%	3	7%
Provision for reorganization and restructuring costs	34	77%	10	23%
Extra-ordinary items	40	91%	4	9%
Profit or loss arising from reorganization or redemption of long term debt	37	84%	7	16%
n = 44				

It is evident from a review of the responses, that there was no overwhelming dissatisfaction with any of the adjusting factors. The adjusting factor which had the least support (41%) for adjustment was "profit or loss on sale of assets". "Goodwill amortization" and "provision for reorganization and restructuring costs" also had some support (25% and 23% respectively) for non-adjustment. The reasons given by management for non-adjustment of items mentioned in table 6.12 are presented below. The respondents reasons are evaluated on the basis of the available guidance in Circular 7/2002. The number of respondents giving the same/similar reason is shown in brackets (where no number is shown, that particular reason was stated by one respondent).

6.7.2.1 Goodwill amortization

Reasons given by the 11 (25%) respondents who stated that "goodwill amortization" should not be a Headline adjustment included:

i. Goodwill is just like a normal fixed asset. It was bought to generate income. As such goodwill amortization (like depreciation) should not be adjusted for (4 respondents).

ii. The amortization of any income producing asset should be part of Headline earnings.

Headline earnings is a measure of trading profit separated from capital items. The standard setters therefore consider goodwill amortization to be a capital item. Whether or not goodwill amortization is a capital item is debatable. Certainly the reasons given by respondents for non-adjustment of "goodwill amortization" do appear to be valid.

6.7.2.2 Profit or loss on sale of assets

Reasons given by the 18 (41%) respondents who stated that "profit/loss on sale of assets" should not be a Headline adjustment included:

i. Disposals of assets take place in the normal course of business (10 respondents).
ii. This is merely an excess or shortfall on depreciation previously charged (4 respondents).
iii. Only abnormal "one-off" assets should be adjusted for (2 respondents).

In developing the Headline earnings definition, a distinction was made between the asset base of a company and the income which the asset base produces. Gains or losses relating to changes in the asset base were classified as capital. As profit or losses from the sale of assets result from changes to a company's asset base, they are a capital item and are correctly excluded from Headline earnings.

6.7.2.3 Profit or loss from the discontinuance of a division or operation

Only 5 (11%) respondents thought that profit or loss from discontinuance should not be an adjusting item. Reasons given by them included:

i. Discontinuance is a normal strategic decision.
ii. Discontinuance occurs in the normal course of business.

However, as profit or loss on sale on discontinuance is clearly a capital item, it is correctly excluded from Headline earnings.

6.7.2.4 Impairment losses on assets

Reasons given by the 9 (20%) respondents who stated that impairment losses on assets should not be a Headline adjustment included:

i. Impairment losses are just like normal depreciation (3 respondents).
ii. They are a consequence of normal business conditions.

iii. They are usually temporary and usually reverse.
iv. It is the result of previous under depreciation.

Reasons given by respondents revolve around the fact that impairment losses are similar to depreciation. As such they feel that it is part of trading performance. The standard setters obviously consider impairment losses to be a capital item. This issue could be argued either way and would depend on the specifics of each separate impairment loss. The author believes that in more cases than not, impairment losses are a capital item.

6.7.2.5 Provision for profit or loss on termination of an operation.

Only 3 (7%) respondents thought that this should not be an adjusting item. No reasons were given. Clearly though, any profit or loss on discontinuance, whether it be actual or a provision, is a capital item. As such it is correctly excluded from Headline earnings.

6.7.2.6 Provision for reorganization and restructuring costs

Reasons given by the 10 (23%) respondents who stated that "provision for reorganization and restructuring costs" should not be a Headline adjustment included:

i. Reorganization and restructuring are part of the ongoing normal operations of a business (5 respondents).
ii. Restructuring costs will increase future profits. So why adjust for the costs but leave the increased future profitability?

Chapter 5 showed that the most common disallowed Headline adjustment was restructuring and reorganization costs, with the affected companies adjusting for actual costs rather than the provision. Due to the relatively high number of companies adjusting for actual restructuring costs it was considered that preparers were possibly confused.

The reasons given (above) by respondents for non-adjustment of "provision for reorganization and restructuring costs" relate to <u>actual</u> reorganization and restructuring cost. As mentioned in chapter 5, actual restructuring costs is a non-adjusting item. It appears that the respondents who gave reasons for the non-adjustment of actual restructuring costs, genuinely think that actual restructuring costs is an adjusting item.

A comparison was done to see how many of the 10 companies/respondents who thought that "actual restructuring costs" was an adjusting item, had in fact adjusted for "actual' restructuring cost in either their 2002 or 2001 financial statements. It was not surprising to find that 6 (60%) of the 10 companies incorrectly adjusted for actual restructuring costs.

6.7.2.7 Extra-ordinary items

Only 4 (9%) respondents thought that extra-ordinary items should not be an adjusting item. No reasons were given by them.

Extra-ordinary events result in capital gains or losses. As such extra-ordinary items are correctly classified as adjusting items.

6.7.2.8 Profit or loss arising from reorganization or redemption of long term debt

Reasons given by the 7 (16%) respondents who stated that "profit or loss from reorganization or redemption of long term debt" should not be a Headline adjustment included:

i. It's part of the normal interest costs to a business (2 respondents).
ii. It occurs in the normal course of business.

As debt relates to the capital structure of a business, any gains or losses arising from changes to that capital base would be a capital item. As such profits or losses from the reorganization or redemption of long term debt is correctly classified as a Headline adjusting item.

6.7.2.9 Summary on allowed Headline adjustments

The common reason cited by respondents for non-adjustment of items, relates to the fact that the item in question occurs in the "normal course of business". In terms of the guidance given in Circular 7/2002, this argument on its own is not valid. Headline earnings is not a measure of performance from "normal operations" but rather a measure of trading performance. The fact that a capital item occurs in the normal course of business, does not make it a trading item (non-capital item).

Based on the above discussions of AC 306's Headline items, the only item which has reasonable success of being a non-adjusting item is "goodwill amortization".

6.7.2.10 Other recommended Headline adjustments

As mentioned earlier, the second part of question 8 asked respondents to suggest other adjusting items. Only two other adjustments were suggested. These are:

i. Profits or losses from the sale shares held as an investment, and
ii. Profits or losses arising from changes in ownership of subsidiaries, associates and joint ventures.

Based on the guidance in AC 306.11 these two items are currently excluded from Headline earnings. AC 306.11 {c} states that profit on sale of assets are excluded from Headline earnings. The paragraph goes on to state that profits or losses on "assets acquired for resale, such as marketable securities" are included in Headline earnings. It is therefore implied that profits or losses from the sale of shares, held as an investment, are excluded from Headline earnings.

AC 306.11 {c} also states that profits or losses arsing from the sale of businesses or changes in their value are excluded from Headline earnings. Therefore profits or losses arising from changes in ownership of subsidiaries, associates and joint ventures are also capital items that are excluded from Headline earnings.

In response to suggestions for other adjusting items, one respondent stated, "No more, Headline adjustments are being abused already".

No new additional adjustments could be suggested by the respondents. This is surprising, especially considering the various disallowed adjustments found in their companies' 2002 and 2001 annual reports (see table 5.6). Had the Financial Managers suggested some of the disallowed adjustments they or their companies had made, this would have indicated that they thought those items should be adjusted for, lending some credibility to the fact that their companies make those adjustments.

In fact all 44 respondents could not suggest other Headline adjustments. It is therefore reasonable to assume that, in so far as new adjustments are concerned, all respondents accept the current Headline earnings definition.

6.7.3 Manipulation of Headline EPS

Question 10 of the questionnaire asked respondents whether they thought that South African companies were manipulating their Headline EPS numbers. The results to this question are presented in table 6.13.

Thirty two respondents (73%) agreed with the question asking if companies in SA manipulate their Headline EPS numbers. Two respondents did not answer this question. This was the only close ended question not answered by all respondents.

Table 6.13: Are companies in SA manipulating their Headline EPS numbers?

	No.	%
Yes	**32**	73%
No	**10**	23%
No reply	2	4%
	44	100%

Other than fraudulent reporting of "net profit/loss for the year", the only way in which Headline EPS can be manipulated is by making disallowed adjustments and/or not making the allowed adjustments. The annual report survey conducted in chapter 5 showed that certain companies in SA are in fact making disallowed Headline adjustments. These contraventions resulted in most affected companies overstating their Headline EPS.

The evidence gathered in chapter 5 therefore supports the views of the majority of respondents, in that companies in SA are manipulating their Headline EPS numbers. However if the Financial Managers, who are the preparers of annual reports, believe that Headline EPS is being manipulated, one has to ask who is doing the manipulating?

Respondents' answers to question 10 were cross checked to the evidence gathered about their company's compliance with the Headline earnings definition, as obtained in the financial statement survey. The results of this investigation are presented in table 6.14.

The results show that 17 (53%) of the 32 respondents/companies who stated that companies manipulate Headline EPS, had themselves contravened the Headline earnings definition. Sixteen of these companies overstated (manipulated) their Headline EPS as a result. Even though 15 respondents/companies stated that companies manipulate Headline EPS, their companies did not contravene the Headline EPS definition for the years inspected.

Seven (70%) of the 10 respondents/companies who stated that Headline EPS is not being manipulated, had complied with the Headline earnings definition. This could have been the reason they answered the way they did. However 3 (30%) respondents who stated that Headline EPS is not being manipulated had contravened the Headline earnings definition. Two of these companies overstated (manipulated) their Headline EPS as a result.

As for the companies who did not answer question 10, one company contravened the Headline earnings definition and one complied with the definition.

The results show that many respondents (16) know that Headline EPS is being manipulated as their own companies overstate Headline EPS. However some respondents (15) know that other companies, as opposed to their own, manipulate their Headline EPS numbers. The financial statement survey conducted in chapter 5 shows that respondents who do not believe that companies manipulate Headline EPS are incorrect.

Table 6.14: Comparison between responses to question 10 and companies contravening the Headline earnings definition

	No.	%
Respondents who stated that companies manipulate Headline EPS	**32**	73%
Their companies contravened the Headline earnings definition	17	53%
Their disallowed adjustments only increased Headline earnings	16	94%
Their disallowed adjustments only decreased Headline earnings	-	-
Their disallowed adjustments increased and decreased Headline earnings	1	6%
Their companies did not contravene the Headline earnings definition	15	47%
	32	100%
Respondents who stated that companies do not manipulate Headline EPS	**10**	23%
Their companies contravened the Headline earnings definition	3	30%
Their disallowed adjustments only increased Headline earnings	2	67%
Their disallowed adjustments only decreased Headline earnings	-	-
Their disallowed adjustments increased and decreased Headline earnings	1	33%
Their companies did not contravene the Headline earnings definition	7	70%
	10	100%
Respondents who did not answer question 10	**2**	4%
His/Her company contravened the Headline earnings definition – adjustment increased Headline earnings	1	50%
His/Her company did not contravene the Headline earnings definition	1	50%
Total respondents	44	100%

6.7.4 Continued disclosure of Headline EPS

The JSE listing requirements require listed companies in SA to disclose Headline EPS. There is no similar requirement in countries like the UK and US. There is a notion that SA should adopt the policy of countries like the UK and US and not disclose Headline

EPS. Respondents were asked whether or not they agreed with such a notion. The results to this question are presented in table 6.15.

Table 6.15: Should SA adopt the policy of the US and UK and not disclose Headline EPS?

	No.	%
Yes	**11**	25%
No	**33**	75%
	44	100%

The majority of respondents (75%) do not support the notion that Headline EPS should not be a disclosable item. However 11 (25%) respondents feel that Headline EPS should not be disclosed.

Due to the weaknesses, as discussed in chapter 2, surrounding Basic EPS and Diluted EPS, the author shares the sentiment of the majority of respondents. Headline EPS is a better measure of performance than Basic and Diluted EPS. Users also support continued disclosure of Headline EPS as they rate it as the most useful EPS measure.
Reasons given by respondents for continued disclosure of Headline EPS are listed below. The number of respondents giving the same/similar reason is shown in brackets (where no number is shown, that particular reason was stated by one respondent). The reasons are:

i. Headline EPS is a better measure of trading performance (5 respondents).
ii. Basic EPS gives no indication of future earnings (2 respondents).
iii. Headline EPS gives an indication of future earnings (2 respondents).
iv. There needs to be a benchmark between companies even if it is not perfect.
v. Headline EPS should continue to be disclosed as long as all reconciling items are disclosed.
vi. Headline EPS provides additional information on which users can make decisions.
vii. If only Basic EPS is disclosed, then companies would be able to ride on high Basic EPS numbers when they contain abnormal profit items, thus giving wrong messages to the uninformed user.

viii. Analysts and businesses need to know what the future outlook is, to make informed decisions.

ix. Headline earnings is a fundamentally logical concept.

x. "We report under UK GAAP. However we still disclose another EPS measure which is similar to South Africa's Headline EPS. They are too many abnormal items these days to force a company to only disclose Basic EPS." (This statement was made by the Financial Manager of the company in chapter 5 that did not disclose Headline EPS as they reported in terms of UK GAAP. This company disclosed EPS before exceptional items instead. See 5.4.1.1).

xi. Given the revised definition of extra-ordinary items, Headline EPS is more meaningful than Basic EPS.

xii. Basic EPS is not comparable between years and companies.

xiii. If Headline EPS is not disclosed, analysts will still have to calculate it on their own.

xiv. Show Headline and Basic EPS. The shareholder can decide which one to use.

xv. Headline EPS is a figure that analysts place a lot of reliance on. Results are for shareholders and analysts. Management should give them what they want/need as opposed to what management wants to tell them.

The reasons given by respondents, for the continued disclosure of Headline EPS, are all reasonable and lend support to the author's view that Headline EPS is a better measure of performance than Basic and Diluted EPS.

Reasons given by respondents as to why Headline EPS should not be disclosed included:

i. Allows for less company manipulation of earnings (2 respondents).

ii. No one can agree on what to adjust for.

iii. The more adjustments and bases for earnings, the more creative accountants will become.

iv. Headline earnings is too easy to manipulate.

v. Companies will no longer make adjustments as they wish.

vi. Headline earnings is being abused. We are close to where we were with the old extra-ordinary item.

vii. SA GAAP should follow IAS guidelines. The whole world is going this way, we should be in front of such a move.

viii. If all the relevant information is disclosed, investors can do their own calculation.

The first six of the eight reasons given by respondents for non-disclosure of Headline EPS relate to company manipulation of Headline EPS. The affected respondents believe that as companies manipulate Headline EPS, Headline EPS is unreliable as a measure of performance.

6.7.5 Need for better guidance on Headline EPS

The questionnaire was sent out in 2001. At that time AC 306 was the only South African pronouncement on Headline EPS. As AC 306 was issued in 1995, it was considered outdated, that is, it was not updated for new statements or changes to statements that existed at the time of its issue. Also as AC 306 was merely an accounting opinion, as opposed to an accounting standard, it was considered that companies were inconsistent with their application of the Headline earnings definition.

As such respondents were asked whether AC 306 should be revised and replaced with a statement of GAAP. The results to this question are presented in table 6.16.

Table 6.16: Should AC 306 be revised and replaced by a statement of GAAP?

	No.	%
Yes	35	80%
No	9	20%
	44	100%

Eighty percent of the respondents wanted AC 306 to be revised and replaced with a statement of GAAP. Consequently it can be concluded that most respondents considered that AC 306 was not good guidance. Also, as AC 306 was an "opinion", it did not have the sanction of the Companies Act. This could have contributed to the abuse of the Headline earnings definition.

Subsequent to sending of the questionnaire, SAICA replaced AC 306 with Circular 7/2002. It would appear that the standard setters also considered that better guidance was needed. Therefore the respondents did get part of their request met as Circular 7/2002 does give better guidance than AC 306. (See chapter 2 for a discussion on Circular 7/2002.)

However Circular 7/2002 is not a statement of GAAP, as the majority of the respondents had wanted. As long as there is no IAS dealing with Headline EPS, there will be no South African "statement" on Headline EPS. Damant (2002) has however indicated that the concept of Headline EPS will be brought to the attention of the IASB which may result in an international position on Headline EPS. (Damant 2002:5).

Whether or not companies will comply better with Circular 7/2002 than they did with AC 306 is uncertain at this stage.

6.8 Other recommended disclosures

Question 14 asked respondents to suggest other EPS disclosures for inclusion in annual financial statements. Only a few respondents had suggestions. These were:

i. Potential dilutive effect of all share options rather than the not for value portion only.
ii. Potential for re-occurrence of any abnormal items affecting earnings.
iii. Impact on EPS of (other company) acquisitions made between year end and the reporting date. The historical earnings of the acquiree can be used to calculate a consolidated EPS.
iv. A reconciliation of how the weighted average number of shares was calculated.

All of the above suggestions are reasonable. However it is unlikely that AC 104, which is based on IAS 33, is going to be amended to include them. However companies could voluntarily disclose this information.

6.9 Summary

In this chapter, certain issues important to the subject of EPS and in particular, Headline EPS, were investigated from the viewpoint of the Financial Managers of the 2000 Financial Mail Top 100 industrial companies.

The survey showed that management consider "cash inflow or outflow for the year" to be the most important measure of company performance. EPS was ranked second. Of the four per share measures (Basic, Diluted, Headline and Cash flow), management consider Headline EPS to be the most important. This finding corroborates firstly, the Suliman (2000) study where she found that users consider Headline EPS to be the most useful EPS measure and secondly, the Hemus and Mildenhall (1994) study, as they found a measure similar to Headline EPS to be more correlated with security valuation than Basic EPS.

Management ranked Cash flow per share as the 3rd important per share measure. This finding corroborates the Suliman (2000) study as she found that users also ranked Cash flow per share as the 3rd useful per share statistic. This finding further corroborates the De Villiers et al (2003) study as they found that EPS was more correlated with share prices than Cash flow per share.

This study also showed that management consider dividend information, such as Dividends per share and dividend yield, to be of very little importance. This finding also corroborates the Suliman (2000) study where she found that users consider Dividends per share to be of little usefulness.

Even though most preparers consider Diluted EPS to be of little importance, most (75%) of them support continued disclosure of Diluted EPS.

Regarding the Headline earnings definition, there was no overwhelming dissatisfaction with any of the current adjusting factors. However, there appears to be misunderstanding regarding some of the allowed Headline earnings adjustments. "Provision for restructuring costs" is a good example as many respondents believe that this adjustment includes actual restructuring costs. Misunderstanding surrounding adjustments is also evident from some respondents suggesting new Headline adjustments that are currently allowed.

No new Headline adjustments were suggested by respondents. Based on evidence gathered from respondents, it can be concluded that South African companies are relatively satisfied with the current Headline earnings definition.

A further area of confusion among respondents relates to whether Headline EPS is a measure of sustainable earnings. The survey showed that most (73%) respondents considered Headline EPS to be a measure of sustainable earnings. Respondents also appear to be confused as to what Headline EPS is a measure of, with many of them believing it to be a measure of profit from normal operations rather than trading activities.

Approximately three in four (73%) respondents stated that Headline EPS is being manipulated. However as they believe Headline EPS to be a "fundamentally logical concept", most of them (75%) support continued disclosure of Headline EPS. Almost all respondents who don't support continued disclosure of Headline EPS, share that view as they believe that company manipulation of Headline EPS makes the number unreliable.

Most (80%) respondents wanted better Headline EPS guidance. Circular 7/2002 should assist in providing such guidance. Chapter seven concludes this dissertation and offers a few recommendations to overcome some of the Headline EPS problems emerging from this survey.

CHAPTER SEVEN

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.1 Summary and conclusions

This research study had the following objectives:

i. To examine the different EPS measures and the financial reporting framework governing their calculation and disclosure,
ii. To review relevant past literature on EPS,
iii. To determine whether South African companies are correctly calculating and disclosing the various EPS measures,
iv. To determine how important the EPS measures are in comparison to other measures of performance,
v. To determine which EPS measure is most important,
vi. To provide insight into Headline EPS by discussing whether company management:
    a) consider Headline earnings to be a measure of sustainable earnings,
    b) agree with the Headline earnings definition,
    c) believe that Headline EPS is manipulated,
    d) support continued disclosure of Headline EPS in SA, and
    e) consider guidance on Headline EPS to be sufficient.

The first objective was achieved in chapter two were the EPS reporting framework was discussed. The second objective was achieved in chapter three where relevant literature was examined. The third objective was achieved by the Financial Statement survey, the results of which were presented in chapter five. Objectives 4, 5 and 6 were achieved by the Financial Manager survey, the results of which were analysed in chapter six. The main research findings of the two research surveys are presented below.

7.2 Main research findings

7.2.1 Financial Statement survey

Based on the findings of the Financial Statement survey, generalizations made about company disclosure of EPS are summarized below.

7.2.1.1 Basic EPS

All companies disclose Basic EPS as required by AC 104. Company disclosure of Basic EPS is good as most companies comply with all the Basic EPS disclosure requirements.

7.2.1.2 Diluted EPS

Company disclosure of Diluted EPS is poor as most companies do not comply with all the Diluted EPS disclosure requirements.

7.2.1.3 Headline EPS

a) Disclosure

Almost all companies disclose Headline EPS. Company disclosure of Headline EPS is good as all companies who disclose Headline EPS, disclose the reconciliation between Basic and Headline earnings.

b) Headline adjustments

The survey found that approximately half of the selected companies had contravened the Headline earnings definition. This resulted in approximately one in three of all companies overstating their Headline EPS.

It is therefore concluded that certain South African companies do manipulate their Headline EPS. This finding is consistent with Hattingh (1999a), as he also found that South African companies manipulate Headline EPS.

7.2.1.4 Voluntary EPS disclosures

Diluted Headline EPS is the most common voluntary EPS measure with approximately one in two companies disclosing it. Despite criticisms levied against EPS with Cash flow per share believed to be a superior measure, only a few companies (approximately one in ten) disclose Cash flow per share. Headline EPS from continuing operations and EPS before exceptional items were other less common voluntary EPS measures found. Company disclosure of voluntary EPS measures is good as most companies disclose the numerator reconciliation.

7.2.2 Financial Manager questionnaire survey

A number of theoretical generalizations were drawn from the survey of Financial Managers. These are summarized below.

7.2.2.1 Importance of measures of performance

The following findings were made regarding the importance of the various measures of company performance:

i. Measures of performance found in annual reports are considered more important than other financial measures of performance not ordinarily found in annual reports,

ii. Cash inflow/outflow for the year, per the Cash Flow Statement, is the most important measure of company performance followed by Headline EPS,

iii. Headline EPS is the most important EPS measure, and

iv. Cash flow per share is considerably less important than Headline EPS.

Headline EPS is the most useful EPS measure Cash flow per share is less important/useful than earnings based per share measures.

7.2.2.2 Diluted EPS

The following findings were made regarding Diluted EPS,

i. From Basic EPS, Diluted EPS, Headline EPS and Cash flow per share, Diluted EPS is the least important per share statistic,

ii. However as Diluted EPS provides meaningful information to users, preparers support continued disclosure of Diluted EPS, and

iii. Diluted EPS is not considered to be a strong indicator of future earnings.

7.2.2.3 Headline EPS

The following findings were made regarding Headline EPS:

i. Preparers incorrectly considered Headline EPS to be a measure of sustainable earnings,

ii. There was no overwhelming dissatisfaction with any of the allowed Headline adjustments and no new Headline adjustments could be suggested, as such the current Headline earnings definition is deemed appropriate,

iii. Preparers are confused over some of the allowed adjustments such as the "provision for restructuring and reorganisation costs",

iv. Preparers concede that Headline EPS is being manipulated,

v. Preparers support continued disclosure of Headline EPS in SA and

vi. Preparers requested better guidance on Headline EPS.

Circular 7/2002 should provide the necessary improved Headline EPS guidance.

7.3 Overview of findings

Even though all companies do not comply with all the relevant disclosure requirements, the study has shown that companies correctly calculate Basic and Diluted EPS. Headline EPS is an area of concern. The study has shown that Headline EPS is considered the most important/useful per share statistic to management.

However, the Financial Statement survey conducted as part of this study showed that South African companies overstate their Headline EPS. This study has also shown that most preparers know that companies manipulate Headline EPS.

7.4 Recommendations

7.4.1 Use of another voluntary EPS measure

Companies should not be using the "Headline EPS" designation for a measure that has not been calculated in accordance with the Headline earnings definition. If companies want to make other "Headline" adjustments, they should disclose an additional "Headline" measure and call it something else for example, "Adjusted Headline EPS".

7.4.2 JSE listing requirements should be amended

As standardization on Headline EPS is not presently possible, it is recommended that the JSE listing requirements be amended requiring all listed companies to expressly state in their EPS note whether or not they have complied with Circular 7/2002's Headline earnings definition. It is likely that this would increase compliance with the Headline earnings definition.

7.4.3 Headline EPS monitoring committee

The regulatory authorities should consider setting up a Headline EPS monitoring committee to monitor company compliance with the Headline earnings definition. Considering the importance of Headline EPS, the benefits derived from such a decision would outweigh any costs involved. In fact, as monitoring compliance with the Headline earnings definition is a straight forward exercise, the costs should be nominal.

This Headline EPS committee could also provide guidance where companies are uncertain about allowed Headline adjustments, for example, provision for restructuring costs and profit or losses on sale of assets.

A Headline EPS monitoring committee would certainly prevent or assist in preventing company abuse of the Headline earnings definition, thereby increasing confidence in this crucial measure of company performance.

7.5 Areas for further research

The following areas for research are identified:

i. Surveying company compliance with Circular 7/2002 to see if more companies comply with the Headline earnings definition since its release and

ii. Studying the correlation between the three EPS measures (Basic, Diluted and Headline) and Cash flow per share to determine which EPS measure most impacts the market. (Hemus and Mildenhall (1994) used a measure similar to Headline EPS, not Headline EPS.)

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Appendix A

LIST OF SELECTED COMPANIES

1 Amalgamated Beverage Industries Ltd
2 AECI Ltd
3 African Harvest Ltd
4 African Oxygen Ltd
5 Afrox Healthcare
6 Aspen Pharmacare Holdings
7 Avis Southern Africa Ltd
8 Barlow Ltd
9 Bateman Project Holdings
10 Bidvest Group
11 Cadbury Schweppes
12 Caxton Publishers and Printers
13 Chemical Services
14 Clinic Holdings
15 Coastal Group Ltd
16 Comparex Holdings
17 Corpcapital Bank
18 Corpcapital Ltd
19 Corpgro
20 CTP Holdings
21 Del Monte Royal Foods
22 Delta Electrical Industries
23 Dimension Data Holdings
24 Distillers Corporations
25 Dorbyl Ltd
26 Dunlop Africa
27 Edward L Bateman
28 Edgards Consolidated Stores
29 Education Investment Corporation
30 Ellerine Holdings
31 Energy Africa
32 Fintech
33 Foschini Ltd
34 Fame Group
35 Grinrod Unicorn Group
36 Group Five
37 Highveld Steel and Vanadium
38 Hunt Leuchars and Hepburn Holdings
39 Illovo Sugar
40 Imperial Holdings
41 Iscor
42 JD Group
43 Leisurenet
44 LTA Ltd
45 Murray and Roberts Holdings
46 Malbak
47 M-Cell Ltd
48 McCarthy Retail
49 Medi-Clinic Corporation
50 Metro Cash and Carry
51 MIH Holdings
52 Monex Ltd
53 Nampak Ltd
54 Naspers Ltd
55 Network Healthcare Holdings
56 New Clicks Holdings
57 Oceana Fishing Group
58 Omnia Holdings
59 OTK Holdings
60 Pepkor Ltd
61 Pick 'n Pay Stores
62 Power Technologies
63 Pretoria Portland Cement
64 Primedia
65 Profurn Ltd
66 Retail Apparel Group
67 Rainbow Chickens
68 Rebhold
69 Relyant Retail
70 Rembrandt Group
71 Reunert
72 South African Breweries
73 Safmarine and Rennies Holdings
74 Sappi
75 Sasol
76 Seardel Investment Corporation
77 Stellenbosch Farmer's Winery
78 Shoprite Holdings
79 Siltek
80 Sun International
81 Speciality Stores
82 Steinhoff International Holdings

83 Super Group
84 Tiger Brands
85 Tiger Wheels Ltd
86 Tongaat Hulett Group
87 Toyota South Africa
88 Trencor Ltd
89 Truworths International
90 United Service Technologies
91 Unitrans Ltd
92 Voltex Holdings
93 Waco International
94 Woolworths Holdings
95 Wooltru Ltd
96 Kolosus Holdings
97 Bell Equipment
98 Grintek Ltd
99 Tridelta Magnet Holdings
100 Concor Ltd

Appendix B

EARNINGS PER SHARE FINANCIAL STATEMENT CHECKLIST

Company Number

1 **BASIC EARNINGS PER SHARE**

1.1 **Current year**

1.1.1 On the face of the income statement

1.1.2 **Numerator** (basic earnings) disclosed in the note
Numerator not disclosed in the notes but = to attributable earnings

1.1.3 Denominator (weighted average number of shares) disclosed

1.1.4 Where more than one class of ordinary share, disclosure of 1.1.1, 1.1.2 and 1.1.3 for each class of ordinary share that has a different right to share in profits

1.2 **Prior year**

1.2.1 On the face of the income statement:

1.2.2 **Numerator** (basic earnings) disclosed in the notes
Numerator not disclosed in the notes but = attributable earnings

1.2.3 Denominator (weighted average number of shares) disclosed

1.2.4 Where more than one class of ordinary share, disclosure of 1.2.1, 1.2.2 and 1.2.3 for each class of ordinary share that has a different right to share in profits

2 **DILUTED EARNINGS PER SHARE**

2.1 **Current year**

2.1.1 On the face of the income statement:
In the EPS note

2.1.2 **Numerator** (diluted earnings) disclosed in the notes
Numerator not disclosed in the notes but = to basic earnings
Numerator not = to basic earnings, reconciliation of numerator disclosed
Numerator not = basic earnings, reconciliation of numerator not disclosed

2.1.3 **Denominator** disclosed in the notes

2.1.4 Reconciliation of **denominators** disclosed
Reconcliation of **denominators** not disclosed
Reconciliation of **denominators** not apllicable - basic eps = diluted eps

2.2 **Prior year**

2.2.1 On the face of the income statement:
In the EPS note

2.2.2 **Numerator** (diluted earnings) disclosed in the notes
Numerator not disclosed in the notes but = to basic earnings
Numerator not = to basic earnings, reconciliation of numerator disclosed
Numerator not = basic earnings, reconciliation of numerator not disclosed

2.2.3 **Denominator** disclosed in the notes

2.2.4 Reconciliation of **denominators** disclosed
Reconcliation of **denominators** not disclosed
Reconciliation of **denominators** not applicable - basic eps = diluted eps

3 HEADLINE EARNINGS PER SHARE

3.1 Disclosure requirements

3.1.1 **Current Year**

3.1.1.1 Headline earnings per share disclosed on the face of income statement
Headline earnings per share disclosed in the note

3.1.1.2 Itemized **reconciliation** between headline earnings and basic earnings, disclosing for each reconciling item the
nature,
amount,
tax effect, and
effect on outside shareholders' interest.

Reconciliation not necessary as Headline EPS = Basic EPS

3.1.1.3 **Denominator** disclosed
Denominator not disclosed but equal to weighted no of basic shares

3.1.1.4 Headline earnings reconciliation disclosed on the face of the income statement

3.1.1.5 Headline EPS commentary and analysis disclosed

3.1.2 **Prior year**

3.1.2.1 Headline earnings per share disclosed on the face of the income statement
Headline earnings per share disclosed in the note

3.1.2.2 Itemized **reconciliation** between headline earnings and basic earnings, disclosing for each reconciling item the
nature,
amount,
tax effect, and
effect on outside shareholders' interest.

Reconciliation not necessary as Headline EPS = Basic EPS

3.1.2.3 **Denominator** disclosed
Denominator not disclosed but equal to weighted no of basic shares

3.1.2.4 Headline earnings reconciliation disclosed on the face of the income statement

3.1.2.5 Headline EPS commentary and analysis disclosed

3.2 Allowed Headline adjustments

3.2.1 **Current year**

3.2.1.1 Profit or loss from the sale or **discontinuance** of an operation or business

3.2.1.2 Profit or loss on sale/variation of interest in **sub/JV/associate**

3.2.1.3 Profit or loss on sale of **investments**/adjustment to fair value

3.2.1.4 Gains or losses on the sale of **fixed assets** or on adjustments (excluding depreciation) to their carrying value

3.2.1.5 Profits or losses from the reorganization or redemption of long term debt

3.2.1.6 Provisions in respect of:
profits or losses on the sale or termination of an operation,
restructuring and reorganization costs and
profits or losses on sale of fixed assets

3.2.1.7 Amortization of or changes in fair value to goodwill

3.2.1.8 Impairment of intangibles

3.2.1.9 Extra-ordinary items

3.2.1.10 Post employment benefits transitional provison

3.2.2 **Prior year**

3.2.2.1 Profit or loss from the sale or **discontinuance** of an operation

3.2.2.2 Profit or loss on sale/variation of interest in **sub/JV/associate**

3.2.2.3 Profit or loss on sale of **investments**/adjustment to fair value

3.2.2.4 Gains or losses on the sale of **fixed assets** or on adjustments (excluding depreciation) to their carrying value

3.2.2.5 Profits or losses from the reorganization or redemption of long term debt

3.2.2.6 Provisions in respect of:
profits or losses on the sale or termination of an operation,
restructuring and reorganization costs and
profits or losses on sale of fixed assets

3.2.2.7 Amortization of or changes in fair value to goodwill

3.2.2.8 Impairment of intangibles

3.2.2.9 Extra-ordinary items

3.2.2.10 Post employment benefits transitional provison

3.3 **Disallowed Headline adjustments**

3.3.1 **Current year**

3.3.2 **Prior year**

4 VOLUNTARY EPS DISCLOSURES

4.1 Diluted Headline EPS

4.1.1 Disclosed on the face of income statement
Disclosed in the EPS note

4.1.2 **Denominator** disclosed in the note
Denominator not disclosed but same as for basic/diluted EPS

4.1.3 **Numerator** equal to Headline earnings and disclosed in the note
Numerator equal to Headline earnings and not disclosed in the note
Numerator not equal to Headline earnings and disclosed in the note

4.1.4 **Reconciliation** between Headline earnings and Diluted Headline earnings disclosed
Reconciliation between Headline earnings and Diluted Headline earnings not disclosed
Reconciliation not necessary as Headline earnings = Diluted Headline earnings

4.2 Cash equivalent EPS

4.2.1 Disclosed on the face of income statement
Disclosed in the EPS note

4.2.2 **Denominator** disclosed in the note
Denominator not disclosed but same as for basic EPS

4.2.3 **Numerator** disclosed in the note

4.2.4 **Reconciliation** between earnings and a cash equivalent earnings disclosed
Reconciliation between earnings and a cash equivalent earnings not disclosed

4.3 Attributable cash flow per share

4.3.1 Disclosed on the face of income statement
Disclosed in the EPS note

4.3.2 **Denominator** disclosed in the note
Denominator not disclosed but same as for basic EPS

4.3.3 **Numerator** disclosed in the note

4.3.4 **Reconciliation** between cash flows from operating activities and attributable cash flow disclosed
Reconciliation between cash flows from operating activities and attributable cash flow not disclosed

4.4 Headline EPS from continuing activites

4.4.1 Disclosed on the face of income statement
Disclosed in the EPS note

4.4.2 **Denominator** disclosed in the note
Denominator not disclosed but same as for basic EPS

4.4.3 **Numerator** disclosed in the note

4.4.4 **Reconciliation** between Continuing Headline earnings and earnings disclosed
Reconciliation between Continuing Headline earnings and earnings not disclosed

4.5 **EPS before exceptional items**

4.5.1 Disclosed on the face of income statement
Disclosed in the EPS note

4.5.2 **Denominator** disclosed in the note
Denominator not disclosed but same as for basic EPS

4.5.3 **Numerator** disclosed in the note

4.5.4 **Reconciliation** between profit before exceptional items and earnings disclosed
Reconciliation between profit before exceptional items and earnings not disclosed

5 **Dividends per share**
Disclosed
Not disclosed

Appendix C

COVERING LETTER TO MAILED QUESTIONNAIRE

20 June 2001

Dear Sir/ Madam

I am conducting a survey to investigate your attitude towards the disclosure of Earnings per share (EPS) and related matters in South Africa. Earnings per share may be defined as the net wealth generated by each share for a period. Earnings per share is an important item of disclosure in corporate financial reporting and your opinion is essential to the accuracy and reliability of the survey results.

Enclosed is a questionnaire, which you are kindly requested to complete and return in the attached reply-paid envelope.

As nearly all questions are pre-structured, completing the questionnaire will take up very little of your time. All the information will be treated as strictly confidential and will be statistically processed together with that of other respondents. Please direct and enquiries about the questionnaire to me on:

Work - 031 560 7096
Home - 031 303 8317
Cell - 083 278 1459

Thanking you in advance for your kind co-operation.

Yours faithfully

Keith Harrod

Appendix D

SURVEY OF ATTITUDES TOWARDS EARNINGS PER SHARE DISCLOSURES

For office

In terms of the statement of GAAP on earnings per share (EPS), AC 104, listed companies are obliged to disclose Basic EPS and Diluted EPS.
In terms of AC 306, the opinion by the Accounting Task Force on Headline EPS, listed companies are recommended to disclose Headline EPS. However in terms of the J.S.E. listing requirements, all listed companies must disclose Headline EPS.

1 2

Based on the above reporting guidelines please answer the following questions:

1) How important are the following accounting measures of performance?
Please score from - 1:not at all important to 5: very important.

Item	(Please tick one box for each item)	Not at all important				Very Important
A	Turnover	1	2	3	4	5
B	Gross Profit	1	2	3	4	5
C	Profit before tax	1	2	3	4	5
D	Profit after tax	1	2	3	4	5
E	Profit attributable to shareholders	1	2	3	4	5
F	Cash inflow/outflow	1	2	3	4	5
G	Net asset value	1	2	3	4	5
H	Earnings per share	1	2	3	4	5
I	Dividends per share	1	2	3	4	5

2) How important are the following accounting and financial measures of performance?
Please score from - 1:not at all important to 5: very important.

Item		(Please tick one box for each item)	Not at all important				Very Important
A		Dividend yield	1	2	3	4	5
B		Headline earnings per share	1	2	3	4	5
C		Price earnings ratio	1	2	3	4	5
D		Basic earnings per share	1	2	3	4	5
E		Diluted earnings per share	1	2	3	4	5
F		Return on assets	1	2	3	4	5
G		Cash flow per share	1	2	3	4	5

3) In terms of the revised AC104, Earnings per Share, Basic EPS is now calculated after extraordinary items. Do you agree with the new treatment ?

Item	(Please tick the appropriate box)
A	Yes
B	No
C	It doesn't matter due to the headline earnings adjustment.

4) In terms of AC104, items of an 'abnormal' nature e.g.. profit or loss on discontinuance and provision for restructuring, should be stated above the line in the calculation of Basic EPS. Do you agree with this treatment ?

For office

Item	(Please tick the appropriate box)
A	Yes
B	No
C	It doesn't matter due to the headline earnings adjustment

5) Headline earnings per share is perceived to be an important number in the annual financial statements. In your opinion, how important is **HEADLINE** EPS?

Item	(Please tick one box only)
A	Extremely important
B	Very important
C	Important
D	Not so important
E	Not at all important

6) In your opinion, is Headline EPS a measure of sustainable earnings ?

Item	(Please tick the appropriate box)
A	Yes
B	No

Please provide a reason for your answer?

7) In your opinion is Headline EPS **perceived** to be a measure of sustainable earnings ?

Item	(Please tick the appropriate box)
A	Yes
B	No

8) AC 306, Headline EPS, lists various items requiring adjustment in the calculation of Headline EPS. Which of these items, as listed below, do you believe should **not** be a headline earnings adjustment? For the items selected, if any, please provide motivation in the space provided next to and below the item(s).

Item	a	(Please tick the appropriate boxes)
A		Goodwill amortisation
B		Profit or loss on sale of asset

For office

C Profit or loss on discontinuance of a division or operation

D Write down of assets/impairment losses

E Provision for profit or loss on termination of an operation.

F Provision for reorganisation and restructuring costs

G Extra - ordinary items

H Profit or loss arising from reorganisation or redemption of long term debt

Please list any other item(s), not mentioned on the previous page, which you believe should be a Headline EPS adjustment and provide a reason as to why, in your opinion, it should be a Headline EPS adjustment

ITEMS	

9) Because AC 306 is merely an opinion by the Accounting Task Force, companies are not consistent with the application of the statement. Items requiring adjustment are not adjusted for or adjustments are made for items other than those mentioned in the statement. Do you believe that this "opinion" should be made a statement of Generally Accepted Accounting Practice with more clear guidance as to the adjustments necessary, in order to ensure comparability between years and among different companies.

Item	(Please tick the appropriate box)
A	Yes
B	No

For office use

10) Do you believe that some companies manipulate their earnings and earnings per share figures to achieve pre-set targets (EPS targeting), release good results or for any other beneficial reason ?

Yes ☐ No ☐

11) There is strong support for the notion that South Africa should adopt the policy of countries like the U.S.A. and the U.K. and not disclose Headline EPS, i.e. only disclose Basic EPS with no adjustment for any "abnormal" (Headline adjustments in terms of of AC 306) items. Do you support this notion ?

Yes ☐ No ☐

Please provide a reason(s) as to why you do or do not support this view.

12) Should diluted earnings per share be disclosed ?

Yes ☐ No ☐

13) In your opinion, how strong a measure of future earnings is Diluted EPS?

Item	(Please tick one box only)	
A	Very strong	☐
B	Strong	☐
C	Not so strong	☐
D	No indication whatsoever	☐

14) In your opinion, what additional disclosures relating to EPS, other than those mentioned in AC 104 should be made in the annual financial statements.

15) How many years of experience do you have in a managerial position?

Please tick the appropriate box.

Item		
A	Less than 5 years	☐
B	5 - 10 years	☐
C	11 - 20 years	☐
D	More than 20 years	☐