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UNLEVERED OPERATING EARNINGS PER SHARE

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Abstract- **Today all major investment decisions are taken based on earnings per share generated by the company. However, the earnings per share suffer from severe limitations. It can be inflated by incorporating higher debt and as well as higher non operating income. Thus, decision solely based on earnings per share may misguide an innocent investor. The Author in this paper has incorporated a new concept of unlevered operating earnings per share. It is hoped that it will help in bringing a more realistic picture of profitability of company.**

***Keywords*-** EPS, Accounting standard, potential equity shares, IFRS, Unlevered

I. INTRODUCTION

The concept of earning per share

Earnings per share show net earnings of a company available to equity shareholders per share of their holdings in the company. It is assumed to be the yardstick for measuring and comparing Company's earnings capacity for their Equity shareholders. Thus, from investor's point of view it is material information which guides and directs their investment decisions.

Legal positions guiding computation of earnings per share

In India, earning per share has been made the part of financial statements. As per part IV schedule VI to the companies act 1956, every company which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earning per share in accordance with accounting standard 20 whether or not its equity shares or potential equity shares are listed on a recognized stock exchange in India.

In India, accounting standards are issued by the Council of Institute of Chartered accountants of India. However as per accounting standard 20, this standard is mandatory only for those enterprises whose equity shares are listed in recognized stock exchange in India.

Out of 35 accounting standards notified by the Ministry of Corporate affairs, Accounting standard on earning per share has also been converged with International Financial Reporting Standards ('IFRS'). The international accounting standard 33, issued by the International Accounting Standards Committee talks about Earning per share. However this standard is applicable to those Entities whose securities are publicly traded or that are in the process of issuing securities to the public.

All above standards require computing two types of earning per share (a) Basic earnings per share and (b) Diluted earnings per share.

Loopholes of Earnings per share

Earnings per share are supposed to be one of the important indicators of profitability per share income generating capacity of Enterprise for its equity shareholders. It guides and directs investment decisions of investors. However a simple analysis exhibits that earning per share is not a true indicator of profitability for equity shareholders rather it misguides the investment

decisions. Two companies similar in all respects may exhibit different earning per share only due to their different capital structures. The company with higher debt will have higher earnings per share in spite of their equal profits and equal total capital employed. However, a company can avail this advantage if its return on investment (profits before interest and taxes upon total capital employed) is greater than interest after taxes. Interest being a cheaper source of finance and further due to deductibility of interest for tax purposes, the company with higher debt reflects higher earnings per share. Further, two companies similar in all respects including their capital structures but except for their nature of profits (operating versus non operating and non recurring income) will reflect equal earning per share even if one company has generated more sales with lesser cost but the other has added non recurring or non operating profits. In today's scenario, companies are frequently playing accounting games to inflate their earning per share.
Thus, relying solely on earning per share as an investment guide may misguide the innocent investors. Since, earning per share forms part of financial statements, the matter is very serious and needs immediate attention.
The basic drawback of relying solely on earning per share as a measure of financial performance is that

(a) It is computed based on historical earnings which may or may not prevail in future
(b) The adoption of different accounting policies may make earning per share different
(c) It is largely affected by Debt- equity mix in the capital structure of the business enterprise
(d) It fails to reflect the operating income generating capacity of a Business Enterprise.

II. Objective

The basic objective of this research paper is to address the problems relating to earnings per share through simple illustrations and real case study of MRF Limited commanding highest earning per share and finally develop a model for computing and presenting earning per share of a business enterprise so that earning per share reflected in the financial statements may truly guide the innocent investors in their decision making process.

III. Limitation

Earnings per share may still be vitiated by adopting a differing accounting policy. Further the earning per share will not reflect earnings at current prices owing to adoption of historical accounting system.

IV. Illustration-I

Companies with same capital employed and same earnings will reflect different earning per share due to difference only in its debt-equity mix.

This phenomenon may be explained with the help of a hypothetical illustration.
Suppose there are three companies Alpha Ltd, Beta Ltd, and Gama Ltd. Their capital structure and earnings and earning per share (EPS) are provided as below-

Company	**Alpha Ltd**	**Beta Ltd**	**Gama Ltd**
Equity share capital of Rs 10 each	15,000	10,000	5,000
10% debt	15,000	20,000	25,,000
Total capital employed	30,000	30,000	30,000
Operating profit before taxes	3,000	3,000	3,000
Non-operating profit before taxes	3,000	3,000	3,000
Interest	1,500	2,000	2,500
Total profit before taxes	4,500	4,000	3,500
Tax on total income @40%	1,800	1,600	1,400
Total profit after taxes	2,700	2,400	2,100
Number of equity shares	1,500	1,000	5,00
Earning per share	1.8	2.4	4.2

It can be seen from above illustration that Gama Ltd is commanding higher EPS even if it has same earnings and capital employed as compared to other two companies. Further, Gama Ltd is also highly leveraged company as compared to the other two with debt-equity ratio of 5:1. This has resorted to due to debt being a cheaper source of capital, easy availability of debt as compared to Equity and further due to deductibility of interest for tax purposes.

V.Illustration-II

Again companies with same debt-equity ratio with same earnings will reflect same EPS even if companies are having different operating profits.

This phenomenon may be explained with the help of a hypothetical illustration.

Suppose there are three companies A Ltd, B Ltd, and C Ltd. Their capital structure and earnings and earning per share (EPS) are provided as below

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Company	A Ltd	B Ltd	C Ltd
Equity share capital of Rs 10 each	15000	15000	15000
10% debt	15000	15000	15000
Total capital employed	30000	30000	30000
Operating profit before taxes	2000	1000	0
Non-operating profit and non recurring income before taxes	4000	5000	6000
Interest	1500	1500	1500
Total profit before taxes	4500	4500	4500
Tax on total income @40%	1800	1800	1800
Total profit after taxes	2700	2700	2700
Number of equity shares	1500	1500	1500
Earnings per share	1.8	1.8	1.8

Among three companies the operating profit of A Ltd is the highest but it has same EPS as that of C Ltd which has zero operating profits.

Now having regard to above two illustrations, what message passes on to an innocent investor who may rely on earning per share as a basis for his investment decisions.

VI. Illustration-III

Two companies having same profitability, same debt-Equity will have different EPS due to existence of reserves in capital structure mix.

A company with higher reserve will command higher EPS. Thus, it is not only Debt-Equity ratio but also the proportion of reserve in Equity which affects EPS. Suppose there are four companies P,Q,R and S. all four companies are exactly similar except the content of reserves in their capital structure mix.

Company	P	Q	R	S
Equity shares of Rs. 10 each	40000	30000	20000	10000
Reserve and surplus	10000	20000	30000	40000
Total shareholder's fund	50000	50000	50000	50000
10% Debt	50000	50000	50000	50000
Total capital employed	100000	100000	100000	100000
Total profit before interest and tax	14000	14000	14000	14000
Interest	5000	5000	5000	5000
Profit after interest	9000	9000	9000	9000
Profit after tax	5400	5400	5400	5400
Number of Equity Shares	4000	3000	2000	1000
Earnings per share	1.35	1.8	2.7	5.4

It can be seen from above illustration that all four companies are similar in all respects except the content of reserve in share holder's fund. The EPS is increasing chronologically with increase in reserve and surplus. It implies that retention of reserves instead of declaring dividend positively impacts EPS.

The concept of unlevered operating earnings per share

A company with higher debt commands higher earnings per share if rate of return on investment is greater than rate of interest. Thus, a company enjoys the benefit of increased EPS due to its increased debt, while the other company with same profit generating capacity with lower debt may be a better choice for investor due to its lesser risk of insolvency. But the investors may not select this company due to its lesser EPS.

The unlevered operating EPS implies the operating EPS that will be generated assuming if the company has no debt. This will generate the better operating income generating capacity of business.

Unlevered operating earnings per share may be computed by the following formula:

$$\frac{Operating\ profit\ after\ taxes}{Existing\ number\ of\ Equity\ shares + \frac{Debt}{Market\ price\ per\ Equity\ share}}$$

A case study of MRF Limited:

To explain the computation of unlevered operating earnings per share, MRF Limited has been selected.

	Year	Sep'12 (Rs. Crores)	Sep'11 (Rs. Crores)	Sep'10 (Rs. Crores)	Sep'09 (Rs. Crores)	Sep'08 (Rs. Crores)
I	Net Sales	11850.68	9716.54	7462.74	5679.57	5060.81
II	Total operating expenses	10589.68	8902.8	6626.47	4974.14	4622.73
III (I-II)	Operating profit before Depreciation	1261	813.74	836.27	705.43	438.08
IV	Depreciation	301.11	247.63	260.75	249.32	169.52
V (III-IV)	Operating profit after Depreciation	959.89	566.11	575.52	456.11	268.56
VI	Tax rate	31.31	56.42	34.66	36.22	33.56
VII	taxes applicable to operating profit	300.55	319.43	199.52	165.24	90.13
VIII (V-VII)	Operating profit after Depreciation and taxes	659.33	246.67	375.99	290.86	178.42
IX	Share Capital	4.24	4.24	4.24	4.24	4.24
XII	Total Debt	1631.43	1516.26	952.49	292.79	962.19
XIII	Existing number of Equity shares	0.424	0.424	0.424	0.424	0.424
XIV	Equivalent number of Equity shares for Debt(Total Debt/ Market price per share of Rs. 12900)	0.126	0.117	0.073	0.022	0.074
XV (XIII+XIV)	Total number of Equity shares had there been no debt (Total Debt / Market price per share of Rs. 12900)	0.550	0.541	0.497	0.446	0.498
XVI (VIII/XV)	Unlevered operating earnings per share	1198.77	455.51	755.25	651.14	357.86
XVII	Reported EPS	1349.54	1460.5	834.63	604.37	334.74

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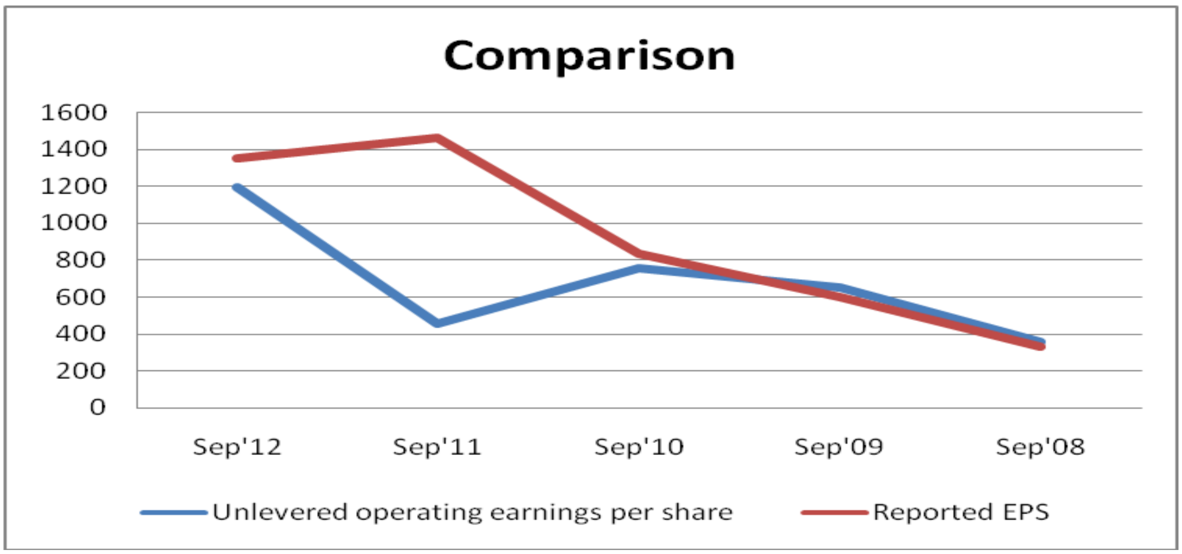
Chart showing comparison between Reported EPS and unlevered operating



From above chart we can easily trace the profitability position of MRF Limited. Year ended September 2011 was an unfavorable year for MRF Limited since its operating profit was very lesser as compared to other years however, it introduced non operating income and as a result the its profit shown an upward trend.

Conclusions

Unlevered operating earnings per share is supposed to be a strong financial measurement tool which the accounting world is lacking today. It will help to measure per share earnings capacity in a better way by avoiding the impact of benefit of debt as well as non operating income on earnings per share.

References :

1) Annual reports of MRF Limited
2) Accounting standard 20 issued by the Institute of Chartered Accountants of India
3) The international accounting standard 33, issued by the International Accounting Standards Committee

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Annexure:

Balance Sheet and Profit and Loss account of MRF Limited

Balance sheet of MRF Limited for last 5 years					
Year	**Sep'12**	**Sep'11**	**Sep'10**	**Sep'09**	**Sep'08**
Liabilities	12 Months	12 Months	12 Months	12 Months	12 Months
Share Capital	4.24	4.24	4.24	4.24	4.24
Reserves & Surplus	2853.56	2293.53	1686.44	1357.18	1116.55
Net Worth	2857.8	2297.77	1690.68	1361.42	1120.79
Secured Loan	1433.34	1209.3	541.95	189.75	634.29
Unsecured Loan	198.09	306.96	410.54	103.04	327.9
TOTAL LIABILITIES	4489.23	3814.03	2643.17	1654.21	2082.98
Assets					
Gross Block	5062.51	3831.82	3367.9	2734.33	2422.56
(-) Acc. Depreciation	2148.71	1860.44	2038.99	1800.77	1556.01
Net Block	2913.8	1971.38	1328.91	933.56	866.55
Capital Work in Progress	414.65	1135.25	497.72	286.24	443.68
Investments	424.71	72.69	77.67	148.57	68.56
Inventories	1645.59	1526.02	1110.68	650.47	984.28
Sundry Debtors	1454.09	1308.09	811.49	580.03	610.05
Cash and Bank	61.1	57.24	52.79	59.89	102.35
Loans and Advances	298.33	269.14	142.29	405.59	307.03
Total Current Assets	3459.11	3160.49	2117.25	1695.98	2003.71
Current Liabilities	2488.51	2318.22	1202.25	966.41	1039.9
Provisions	234.53	207.56	176.13	443.73	259.62
Total Current Liabilities	2723.04	2525.78	1378.38	1410.14	1299.52
NET CURRENT ASSETS	736.07	634.71	738.87	285.84	704.19
Misc. Expenses	0	0	0	0	0
TOTAL ASSETS(A+B+C+D+E)	4489.23	3814.03	2643.17	1654.21	2082.9
Profit and Loss account of MRF Limited for last 5 years					
	Sep'12	**Sep'11**	**Sep'10**	**Sep'09**	**Sep'08**
	12Months	12Months	12Months	12Months	12Months
INCOME:					

Sales Turnover	13061.75	10644.86	8104.31	6164.06	5731.63
Excise Duty	1211.07	928.32	641.57	484.49	670.82
NET SALES	11850.68	9716.54	7462.74	5679.57	5060.81
Other Income	32.01	14.1	6.35	5.2	4.54
TOTAL INCOME	11882.69	9730.64	7469.09	5684.77	5065.35
EXPENDITURE:					
Manufacturing Expenses	668.98	570.57	516	361.71	382.75
Material Consumed	8553.26	7283.46	5156.78	3827.44	3556.19
Personal Expenses	513.69	446.75	378.17	316.82	275.71
Selling Expenses	0	465.3	444.64	365.27	314.54
Administrative Expenses	853.75	136.72	130.88	102.9	93.54
Expenses Capitalised	0	0	0	0	0
Provisions Made	0	0	0	0	0
TOTAL EXPENDITURE	10589.68	8902.8	6626.47	4974.14	4622.73
Operating Profit	1261	813.74	836.27	705.43	438.08
EBITDA	1293.01	827.84	842.62	710.63	442.62
Depreciation	301.11	247.63	260.75	249.32	169.52
Other Write-offs	0	0	0	0	0
EBIT	991.9	580.21	581.87	461.31	273.1
Interest	158.78	93.02	63.1	68.92	66.25
EBT	833.12	487.19	518.77	392.39	206.85
Taxes	260.86	274.9	179.85	142.16	69.42
Profit and Loss for the Year	572.26	212.29	338.92	250.23	137.43
Non Recurring Items	0	2.23	14.24	6.09	-6.76
Other Non Cash Adjustments	0.1	404.9	0.82	-3.29	13.89
Other Adjustments	0	0	0	3.29	-2.59
REPORTED PAT	572.36	619.42	353.98	256.32	141.97
KEY ITEMS					
Preference Dividend	0	0	0	0	0
Equity Dividend	10.6	10.6	21.2	10.6	8.48
Equity Dividend (%)	250	250	500	250	200
Shares in Issue (Lakhs)	42.41	42.41	42.41	42.41	42.41
EPS - Annualised (Rs)	1349.54	1460.5	834.63	604.37	334.74