

Investment basics – X

The effect of taxation on earnings per share

Earnings per share (EPS) means the income in cents attributable to each equity share, based on the consolidated net income for the period, *after tax*, and after deducting outside shareholders interests and preference dividends, but before extraordinary items, divided by the weighted average number of equity shares in issue and ranking for dividend in respect of the period.

In comparing pre-tax EPS with post-tax EPS, and assuming a standard rate of tax of say 42%, pre-tax EPS of say 100c would be reduced to 58c post-tax.

This assumes of course that pre-tax earnings are taxable in full but in reality this is seldom the case for any of the following reasons:

1. income receivable which is not taxable – e.g. dividends;
2. expenditure which is disallowable – e.g. certain types of donations, certain foreign expenses, provisions in general etc;
3. special allowances such as exporters' allowances, plant and machinery and building investment allowances, training allowances etc;
4. the utilization of prior tax losses;
5. in the case of mining companies – expenditure on capital assets.

With the exception of (2) above taxable earnings are appropriately reduced resulting in a lower percentage tax rate.

There exists in South Africa a generally accepted accounting practice which recommends in essence that a reconciliation be made between the rate of tax included in the accounts and the actual ruling rate of taxation. This disclosure, where applied, is of considerable aid to the investment analyst in that it enables him to make whatever adjustments he deems necessary to past EPS and future projections (as far as they are affected by taxation).

These disclosures will of course only act as a guideline in assisting the analyst to determine the effect they have had on past profits and are likely to affect future profits. One would have to examine each of these in turn in relation to the nature of the company's business in order to establish items that are recurring and those which are strictly once off. For example a company that historically earns say 80% of its distributable income in the form of dividend income will continue to reflect a relatively low rate of tax. On the other hand companies enjoying the plant and machinery investment allowance will only reflect the tax benefit when replacing or expanding their existing plant, whereas a company involved in the export trade will enjoy the exporters' allowance on a continual basis.

The following example is a simple illustration of the reconciliation of rate of tax and EPS before and after taxation:

	Company A		Company B	
	R	EPS	R	EPS
Profit before tax (1 m shares)	1 000 000	R1,00	1 000 000	R1,00
Tax – (normal rate – 42%)	26,0%	260 000	42%	420 000
Tax loss – previous year	4,2%†	100 000	—	—
Dividend income	8,4%†	200 000	—	—
*Special allowances	1,3%†	(1) 30 000	—	—
	2,1%†	(2) 50 000	—	—
Profit after tax	R740 000	R0,74	R580 000	R0,58

Apart from the items mentioned in (1) to (5) above, tax payable in a particular year can be materially reduced by a change in the basis of valuing stock. Such a situation arises where a company changes from valuing stock on an average cost or first-in first-out basis (fifo) – to that of last-in first-out (lifo) – a practice becoming more and more popular in these inflationary times.

Whilst on the subject of stock, it is of prime importance in comparing EPS of companies operating in the same 'industry' to establish the method these companies use to value stock.

Apart from these differing methods of valuing stock such as lifo and fifo it is possible, particularly where by-products

are involved, that the accounting treatment of the revenue from such products is such that one company may treat the income as sundry revenue whilst another (in the same industry) may wish to treat such revenue as a reduction of cost of production of the main product. The latter treatment normally results in a lower cost per unit of the main product and consequently a lower cost of stock or work in progress, resulting (assuming all other things equal!) in a smaller tax bill.

Fortunately the information relating to the method of accounting for these items has to be fully disclosed in the notes to the accounts.

† Percentage reduction in normal rate of tax due to the effect on taxable income of the inclusion of these items.

*1. **Investment allowances** of 30% on plant and machinery costing R100 000. (Assume B does not qualify for the allowances and ignore the initial allowance of 25% available to A as this will even itself out between A and B for tax purposes over the life of the assets.)

2. **Exports allowances** – Assume that A exports its product overseas while B does not. Expenditure qualifying for the allowance is R50 000 and A is entitled to 100% of the allowance.

Set out below is a simple comparison of the LIFO and FIFO methods of stock valuation. Note that while company B (FIFO) shows the larger profit, it pays more tax than A and subsequently has that much less cash.

	LIFO	FIFO
1. Closing stock year 1 100 units R10 per unit	R1 000	R1 000
2. Purchases year 2 500 units R15 per unit	R7 500	R7 500
3. Closing stock year 2 100 units R15 per unit	(R1 000)	(R1 500)
4. Cost of sales		
5. Sales year 2 500 units R20 per unit	R7 500	R7 000
Profit before tax	R10 000	R10 000
6. Tax at 42%	R2 500	R3 000
	R1 050	R1 260
Profit after tax	R1 450	R1 740
Net cash [5 - (2 + 6)]	R1 450	R1 240

When it comes to reporting EPS in mining companies it would be fair to say that there is little or no consistency.

Some mines show EPS before allowing for capital expenditure while others show EPS after allowing for capital expenditure thus reflecting an amount that is 'distributable'.

The real point in referring to this method of reporting EPS is that capital expenditure is allowable in full as a deduction for tax purposes in the year in which it is incurred. As capital expenditure is not shown as an expense in the income statement (it is usually reflected as an appropriation from after-tax profits, below the line) yet allowed as an expense for tax purposes, the result would be an appropriately lower rate of tax in any year in which there is capital expenditure. This leads to widely fluctuating rates of tax, relative to pre-tax profits, from year to year.

In certain mining industries such as coal mining this problem may be overcome to some extent by amortizing the assets of the mine over a declared period of time and accordingly creating a provision for deferred taxation. This treatment results in the standard rate of tax being charged against profits on an annual basis.

One mining group in particular has changed its accounting policies over the past few years so as to reflect as correctly

as possible EPS that are distributable. The first stage consisted of breaking down capital expenditure into 'maintenance capital' and 'expansion capital' – the former expense being treated as a charge against profits – above the line. The next stage was to include the tax relief obtained from the 'expansion capital' as a charge above the line – described as tax normalisation – reflecting in effect the tax that would have been payable had the company not incurred the capital expenditure – and consequently showing a lower appropriation below the line representing the after tax cost of the capital expenditure. This particular method of reporting falls somewhere between reporting EPS without taking into account capital expenditure and the resulting tax benefit and perhaps the more pragmatic method of reporting EPS after allowing for capital expenditure. It does, however, reflect more accurately in the accounts of the company the tax consequences of investing in both maintenance and expansion 'capital'.

On balance (ignoring extremes) there is usually enough information available in the accounts of a company to enable the analyst to determine a reasonable rate of tax in estimating future EPS. There is little doubt that a certain skill is required in order to uncover, assimilate and extrapolate all this information.