Chapter 12

Things to Consider About Per-Share Earnings

Two Pieces of Advice

- Don’t take a single year’s earnings seriously

- If you do pay attention to short-term earnings, look out for booby traps in the per-share figures

If our first warning were followed strictly the second would be unnecessary. But it is too much to expect that most shareholders can relate all their common-stock decisions to the long-term record and the long-term prospects. The quarterly figures, and especially the annual figures, receive major attention in financial circles, and this emphasis can hardly fail to have its impact on the investor’s thinking. He may well need some education in this area, for it abounds in misleading possibilities.

Earnings of ALCOA

What do all these additional earnings mean? Which earnings are true earnings for the year and the December quarter? With different earnings, the P/E can be drastically different.

	1970	*1969*
Primary earnings	$5.20	$5.58
Net income (after special charges)	4.32	5.58
Fully diluted, before special charges	5.01	5.35
Fully diluted, after special charges	4.19	5.35

For the fourth quarter alone only two figures are given:

Primary earnings	$1.58	$1.56
Net income (after special charges)	.70	1.56

"Dilution": the reduction from $5.20 to $5.01. ALCOA has a large bond issue convertible into common stock. making allowance for conversion rights—and the existence of stock-purchase warrants—can reduce the apparent earnings by half, or more.

Earnings of ALCOA – cont.

“Special charges”: This figure of $18,800,000, or 88 cents per share, deducted in the fourth quarter, is not unimportant.

The deductions came from four sources, viz.:

1. Management’s estimate of the anticipated costs of closing down the manufactured products division.
2. Ditto for closing down ALCOA Castings Co.’s plants.
3. Ditto for losses in phasing out ALCOA Credit Co.
4. Also, estimated costs of $5.3 million associated with completion of the contract for a “curtain wall.”

All of these items are related to future costs and losses. It is easy to say that they are not part of the “regular operating results” of 1970—but if so, where do they belong? Are they so “extraordinary and nonrecurring” as to belong nowhere?

By anticipating future losses the company escapes the necessity of allocating the losses themselves to an identifiable year. If the ALCOA figure represents future losses before the related tax credit, then not only will future earnings be freed from the weight of these charges (as they are actually incurred), but they will be increased bya tax credit of some 50% thereof.

Earnings of ALCOA – cont.

“True Earning”: The $5.01 per share, after “dilution,” less that part of the 82 cents of “special charges” that may properly be attributed to occurrences in 1970. But we do not know what that portion is, and hence we cannot properly state the true earnings for the year. The management and the auditors should have provided for deduction of the balance of these charges from the ordinary earnings of a suitable number of future years—say, not more than five.

Accounting Factors

1. The use of **special charges**, which may never be reflected in the per-share earnings.
2. The reduction in the normal income-tax deduction by reason of past losses.
3. The **dilution** factor implicit in the existence of substantial amounts of convertible securities or warrants.
4. The method of treating depreciation —chiefly as between the "straight-line" and the "accelerated" schedules.
5. The choice between charging off research and development costs in the year they are incurred or amortizing them over a period of years.
6. The choice between the FIFO (first-in-first-out) and LIFO (last-in-first-out) methods of valuing inventories

An obvious remark here would be that investors should not pay any attention to these accounting variables if the amounts involved are relatively small. But Wall Street being as it is, even items quite minor in themselves can be taken seriously.

Accounting Factors – from Jason Zweig's footnote

7. One is "pro forma" or "as if" financial statements, which report a company's earnings as if Generally Accepted Accounting Principles (GAAP) did not apply.
8. The dilutive effect of issuing millions of stock options for executive compensation, then buying back millions of shares to keep those options from reducing the value of the common stock.
9. Unrealistic assumptions of return on the company's pension funds, which can artificially inflate earnings in good years and depress them in bad.
10. "Special Purpose Entities," or affiliated firms or partnerships that buy risky assets or liabilities of the company and thus "remove" those financial risks from the company's balance sheet.
11. The treatment of marketing or other "soft" costs as assets of the company, rather than as normal expenses of doing business.

Accounting Factors – summary

All this may be confusing and wearisome to our readers, but it belongs in our story. Corporate accounting is often tricky; security analysis can be complicated; stock valuations are really dependable only in exceptional cases.

For most investors it would be probably best to assure themselves that they are getting good value for the prices they pay, and let it go at that.

Use of Average Earnings

In former times analysts and investors paid considerable attention to the average earnings over a fairly long period in the past— usually from seven to ten years. This “mean figure” was useful for ironing out the frequent ups and downs of the business cycle, and it was thought to give a better idea of the company’s earning power than the results of the latest year alone.

Calculation of the Past Growth Rate

We suggest that the growth rate itself be calculated by comparing the average of the last three years with corresponding figures ten years earlier. (Where there is a problem of "special charges or credits" it may be dealt with on some compromise basis.)

ALCOA past growth rate was excellent, actually a bit better than that of acclaimed Sears Roebuck and much higher than that of the DJIA composite. But the market price at the beginning of 1971 seemed to pay no attention to this fine performance. Why?

Evidently Wall Street has fairly pessimistic views about the future course of ALCOA's earnings, in contrast with its past record.

It should be pointed out that ALCOA's earnings on capital funds* had been only average or less, and this may be the decisive factor here. High multipliers have been maintained in the stock market only if the company has maintained better than average profitability.

Calculation of the Past Growth Rate – two-part appraisal process

1. “past-performance value” for ALCOA of 10% of the DJIA, or $84 per share relative to the closing price of 840 for the DJIA in 1970. On this basis the shares would have appeared quite attractive at their price of 57 1⁄4.
2. To what extent should the senior analyst have marked down the “past-performance value” to allow for adverse developments that he saw in the future? Frankly, we have no idea.
3. Assume he had reason to believe that the 1971 earnings would be as low as $2.50 per share—a large drop from the 1970 figure, as against an advance expected for the DJIA. Very likely the stock market would take this poor performance quite seriously, but would it really establish the once mighty Aluminum Company of America as a relatively unprofitable enterprise, to be valued at less than its tangible assets behind the shares?