PRICE – EARNINGS RATIO

$$\text{P/E Ratio} = \frac{\text{Current Market Price Per Share}}{\text{Earnings Per Share}}$$

The price earnings ratio is a measure of how the stock market views the shares of an entity. A relatively high P/E usually suggests that the shares are regarded as a safe investment and investors expect significant future earnings growth. Lower P/Es suggest risk , volatility and poor growth prospects. However , it is unsafe to generalise too much. Where a listed company has become a highly fashionable investment for some reason (e.g. technology shares have in the past been regarded in this way from time to time) , its high P/E ratio may help to mask fundamental weaknesses

SECTION B – 30 MARKS

[indicative time for answering this Section is 54 minutes]

ANSWER ALL THREE QUESTIONS

Question Two

Earnings per share (EPS) is generally regarded as a key accounting ratio for use by investors and others. Like all accounting ratios, however, it has its limitations. You have been asked to make a brief presentation to CIMA students on the topic.

Required:

(a) Explain why EPS is regarded as so important that the IASB has issued an accounting standard on its calculation;

(2 marks)

(b) Explain the general limitations of the EPS accounting ratio and its specific limitations for investors who are comparing the performance of different entities.

(8 marks)

(Total for Question Two = 10 marks)

Answer to Question Two

Notes on earnings per share

(a) EPS is of particular importance because it is one of the component parts of the Price/Earnings (P/E) ratio. P/E is used by investors to help them identify the relative riskiness of investments, and investments that are over-valued or under-valued by the stock market. Also, EPS is accorded great importance by investors, analysts and others as a key measurement of performance and as a basis for making decisions. It is principally for these reasons that some accounting standard setters, amongst them the IASB, have produced accounting standards regulating its calculation.

(b) The principal general limitations of EPS include the following:

- EPS is based on accounting figures, and can only be as reliable as those figures. Accounting figures may be subject to manipulation by using creative accounting techniques. Even where no malicious manipulation is intended, the figures are often imprecise because they involve the use of estimation.
- EPS is essentially a backward looking measure because it is based on accounting figures reporting on transactions and events that have already taken place. It is of limited use for predictive purposes, although, perhaps inevitably, it is used as an indicator of future performance.
- EPS, like all other accounting information published in the annual report of a business, is soon out of date. The P/E ratio calculation uses an up to date price figure, but where the price has been affected significantly by events after the balance sheet date, the mixing of a current price with an old earnings figure may be, essentially, meaningless.

The specific limitations of EPS for the purposes of making comparisons include the following:

- The number of shares in issue is rarely compatible between entities.
- In some instances, accounting standards permit a choice of accounting treatments. It is quite likely, therefore, that entities being compared with each other use different policies and/or bases for preparation of the financial statements. Where such policies and bases impact upon the profit figure, as will usually be the case, EPS figures are not strictly comparable.
- The problem of comparability is made worse where the entities being compared are subject to different sets of accounting standards.
- EPS is calculated on the basis of after tax figures. Where entities are subject to significantly differing rates of tax because they are based in different countries, the comparison is unrealistic.