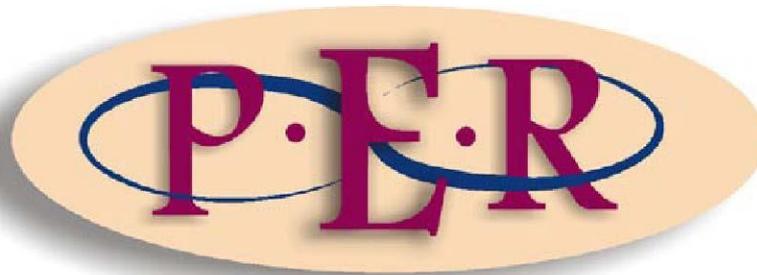


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**THE LEGAL IMPLICATIONS OF THE ECONOMIC REALITIES OF
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PER SHARE - IF ANY**

CG Kilian*
E Snyman-Van Deventer**

1 Earnings per share: background and introduction

1.1 Background

The topic of earnings per share is certainly not a popular research topic, nor is it regularly encountered in law journals or case-law judgments. It remains a largely unexplored yet intriguing research area, and is known as the most unexamined field in company law. Not surprisingly, therefore, it is sometimes difficult to explain what the concept of earnings per share is. Schedule 4 to the *Companies Act* of 1973¹ defines it as follows:

... the earnings attributable to each equity share, based on the consolidated net income for the period, after tax, and after deducting outside shareholders' interest and preference dividends, divided by the weighted average number of that class of share in issue.

The *Companies Act* of 2008,² however, provides no definition or suitable explanation of earnings per share.

In considering why a listed share has a very high or low price on the Johannesburg Stock Exchange (JSE Ltd), earnings per share constitute the economic basis for interpreting such a price. Although probably oversimplified, calculating "earnings per share" or the "earnings-per-share ratio" entails the activity of dividing the net profit

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¹ *Companies Act* 61 of 1973.

² *Companies Act* 71 of 2008.

of a company by the number of its issued shares.³ There have been many responses to this core explanation. The economic reality is that companies may use innovation and creativity to lawfully engineer a better earnings-per-share ratio in order to attract more shareholder investments.⁴ Having thus determined that the relevant share price pertains to the number of issued shares, "earnings per share" encapsulates the economic reality that the number of issued shares may decrease artificially through creative engineering. After all, the law does not prohibit statutory financial engineering.

The purpose of this article is to consider section 75 in the South African *Companies Act* of 1973, or its equivalent (section 36(2)) in the new South African *Companies Act* of 2008), and the topic of statutory approval for an artificial decrease or increase in the number of issued shares. The economic-reality argument is based on section 85 of the *Companies Act* of 1973 or its equivalent in Act 2008 (sections 48 refers to section 46(1)c and section 46(1)c refers to section 4 of the Act), which illustrates that section 75 or its equivalent in the Act of 2008 (section 36(2)) is not subject to any liquidity or solvency requirements. In fact, section 75 or its equivalent in the Act of 2008 does not require a reason for limiting or preventing the artificial decrease or increase of the number of shares through financial engineering.

1.2 Introduction

Neither the *Companies Act* of 1973 nor that of 2008 makes any provision for the maximum or minimum amount of capital required to float a company, or the minimum number of shares that should be issued. This depends solely on the promoters' discretion of the number of shares that must equal the capital amount.⁵ It is therefore possible that the promoters may excessively exercise their discretion when deciding on the authorised share capital, and later tailor-make or financially engineer the share capital structure of the business to make it attractive to

³ Smullen and Hand *Dictionary* 148.

⁴ Bannock, Baxter and Davis *Dictionary* 107.

⁵ Cilliers *et al Corporate Law* para 16.20. The rules of the JSE require shares to be issued for at least R1 per share - see *Amalgamated Packaging Industries (Rhodesia) Ltd* 1963 1 SA 335 (SR); *Ex Parte Rietfontein Estates Ltd* 1976 1 SA 175 (W); *Companies Act* 61 of 1973.

shareholders or future shareholders.⁶ For example, the earnings per share are calculated by dividing retained profits (net profit) by the number of shares issued.⁷ Similarly, a shareholder of a listed company could divide the market price per share of a listed company by the earnings per share in order to calculate the investment attractiveness of a listed share, which is known as the "price-to-earnings ratio".⁸

This article considers possible methods of preventing or limiting artificial increases in earnings per share.⁹ The word "artificial" in this instance is not meant in the sense of an artificially inflated turnover, but rather to denote the artificial engineering of the number of issued shares to increase the earnings-per-share ratio, without an actual increase in the company's turnover or in the net profits through normal business operations. The word "artificial" should therefore be understood in the context of clever financial engineering of the number of shares issued to the shareholders of the company.¹⁰ First, however, it is important to consider the capital rule philosophy in South Africa pertaining to section 85 of the 1973 *Companies Act* as it was amended in Act 37 of 1999, and its significant contribution to the field of the maintenance of share capital in the 2008 *Companies Act*.

⁶ Walsh *Key Management Ratios* 82. The excess cash will increase the "total assets" as disclosed in the balance sheet. The return on total assets ratio will thus produce an indication of ineffective asset utilisation by the management to produce sales/turnover. A promoter is not required to have any business background or financial qualifications to float a company.

⁷ Benade *et al Entrepreneurial Law* 150. Although the company's constitution is a public document, the issue price par value is of no importance. This is clearly evident from the philosophy pertaining to no-par value shares. If an unlisted public company issues 20 million shares at 1c each, the earnings per share would be less than in the case of 10 million shares at 2c each.

⁸ See in general *Ex Parte Seafoods Successors Ltd* 1957 3 SA 73 (D); *Ex Parte Rattham & Son (Pty) Ltd* 1959 2 SA 741 (SR); *Ex Parte Associated Lead Manufacturers (Pty) Ltd* 1960 2 SA 36 (D).

⁹ Stainbank and Harrod *Meditari* 91. These authors suggested that earnings per share should be stated in the company's financial statements. Also see De Villiers *et al SEE* 95; Auret and De Villiers 2000 *SEE* 39.

¹⁰ Walsh *Key Management Ratios* 260-275; Vigario *Managerial Accounting* 285; *Katzoff v Glaser* 1948 4 SA 630 (T) 636: "...the value of anything is what it is worth at the time". In *Dean v Prince* 1954 1 All ER 749 (CA), the court remarked that there is no accountancy principle that fixes or limits the calculation of the value of shares. Also see *Donaldson Investments v Anglo-Transvaal Collieries* 1979 3 SA 713 (W) 731H-732B.

2 The new and old capital rule philosophy in South Africa

2.1 *The new philosophy (1999)*

Indeed, company law philosophy pertaining to capital rules has expanded rapidly in recent decades, partly due to the growing statutory importance of the new *Companies Act* 2008, and its economic significance to shareholders. Thus, as the relevant literature that covers the period from 1887 to 1999 is too voluminous to consider exhaustively, this article only briefly focuses on the significant law-orientated contributions in the two separate timeframes of 1887 and 1999. For practical purposes the "new" capital rules introduced in 1999 by the amended section 85 of the 1973 *Companies Act* are discussed first.

In terms of these rules, the company may acquire its own shares (as a method to decrease the number of issued shares), if the financial ratios in section 85 have been adhered to.¹¹ The ratios as disclosed by section 85 as amended in Act 37 of 1999 are those most widely used in the financial industry to determine the financial position of a company before the company is allowed to acquire its issued shares, particularly the liquidity (cash in hand) and solvency ratios (assets exceed liabilities). The purpose of the "new" capital rules was to benefit the shareholders of the company without any prejudice to the company's creditors should the company decide to acquire its own shares.¹² However, it has become increasingly obvious that the acquisition of own shares has quite the opposite, positive effect by influencing the earnings per share directly. This has interesting implications in the light of section 85's requirement for creditor protection through the solvency and liquidity ratios. Before section 85 was amended in Act 37 of 1999, section 85 had no liquidity or

¹¹ *Companies Amendment Act* 37 of 1999; Pretorius *et al Company Law* (6th ed) 121; Brews *Take-over Regulation* 28, 142.

¹² Section 85(4) of the *Companies Act* 61 of 1973: "A company shall not make any payment in whatever form to acquire any share issued by the company if there are reasonable grounds for believing that - (a) the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business or (b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company."

solvency ratios as requirements to support or validate a buy-back of company shares.¹³

Yet there are also certain drawbacks to these ratios as statutory requirements. As the balance statement of a company discloses the financial position of that company only on a specific date,¹⁴ an accountant can choose a date to "window-dress" the balance statement favourably so as to comply with the statutory ratios of section 85 as amended in 1999.¹⁵ On the other hand, the balance sheet presents only a snapshot of the company's financial affairs on a specific day, and remains relevant until the next financial year-end (a twelve-month period). To neutralise the latter circumstance, one can argue that an auditor should instead disclose the weighted average cost of capital in relation to the internal rate of return in the company's balance sheet. If the internal rate of return is less than the weighted average cost of capital, this would imply that the company is unable to pay its debts as they become due, and should consequently not be allowed to acquire any of its shares.¹⁶ Nevertheless, due to the difficulties associated with the correct calculation of an internal rate of return, the 2008 *Companies Act* has rectified this by introducing a time period of twelve months. In economic terms, the 2008 Act requires not only a solvency and liquidity ratio but also a twelve-month period to support or validate the buy-back of shares. Both the proposed *Companies Bill* of 2007¹⁷ and the 2008 Act state as follows in section 4 (as referred to in sections 46 and 48) which is the equivalent of section 85 of the Act of 1999:¹⁸

¹³ Section 85(1)-(3) of the *Companies Act* 61 of 1973 required the permission of creditors to allow for a buy-back of company shares.

¹⁴ *Hoice Holdings Ltd v Yabeng Investment Holding Co Ltd* 2001 3 SA 1350 (W); *Capitex Bank Ltd v Qorus Holdings Ltd* 2003 3 SA 302 (W).

¹⁵ SAICA *Financial Statements*; Walsh *Key Management Ratios* 82. The cash-flow cycle also depends on the balance sheet information. Also see *Klein v Kolosus Holdings Ltd* 2003 6 SA 198 (T); *Cachalia v De Klerk and Benjamin* 1952 4 SA 672 (T); *Extel Industrial (Pty) Ltd v Crown Mills (Pty) Ltd* 1999 2 SA 719 (SCA) 732F; *Ilic v Parginos* 1985 1 SA 795 (A) 803D; *Kleynhans v Van der Westhuizen* 1970 2 SA 742 (A); *Knox D'Arcy Ltd v Jamieson* 1996 4 SA 348 (A).

¹⁶ See *Donaldson Investments v Anglo-Transvaal Collieries* 1979 3 SA (W) 731H, 732B. Shareholder value is not calculated by means of the earnings per share times the number of issued shares.

¹⁷ *Companies Bill*, 2007 [B61-2008].

¹⁸ The 2008 Act contains similar wording.

- (1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time –
- (a) the company's total assets equal or exceed its total liabilities; and
 - (b) it appears that the company will be able to pay its debts as they became due in the course of business for a period of –
 - (i) 12 months after the date on which the test is considered.¹⁹

The time period included in this section has implicitly introduced the relationship between the internal rate of return and the weighted average cost of capital. Even though it is not a requirement to disclose this relationship in any financial statement to determine whether the company will actually be able to comply with the twelve-month time period, it is at least a continuous requirement up to the next financial year-end. If the internal rate of return is less than the weighted average of the cost of capital, we can assume that the company will not be able to service its debts as they become due - thereby breaching the twelve-month time period.²⁰ If it is able to pay its debts for a period longer than twelve months, this implies true company liquidity.²¹ On the other hand, the requirements in section 4 or 85 can be avoided by making use of section 75 or its equivalent (section 36(2)) in the 2008 Act. Section 75 or section 36(2) requires no liquidity or solvency ratios nor a twelve-month time period as requirements to support or validate the decrease or increase in the number of issued shares. Due to the latter, the following question is posed: is the decrease or increase of issued shares an *intra vires* act?

¹⁹ Section 4(1)(b)(i) of the *Companies Act* 71 of 2008 also refers to 12 months.

²⁰ Atkinson *Financial Collapse* 46: "Notwithstanding the apparent success of the use of ratio analysis in the prediction of company failure, it should be noted that some researchers comment that, while ratios of failed firms were found to be significantly different from those of non-failed firms, the ability of such ratios to predict failure was not so conclusive." In this regard, the internal rate of return should be calculated and compared to the weighted average cost of capital. If the internal rate of return is less, the forecast value of the company would be less than that of a company able to create a greater internal rate of return.

²¹ Black, Wright and Davies *In Search of Shareholder Value* 23: "We raise capital ... sell it at an operating profit. Then we pay the cost of the capital. Shareholders pocket the difference." The greater the liabilities, the greater the weighted average cost of capital, and consequently, the less the profits. Also see Delpont *Verkryging van Kapitaal* 205.

2.2 *The old philosophy (1887)*

One of the cornerstones of company law is the matter *Trevor v Whitworth*.²² The *Trevor* case laid down a very important principle in 1887, although perhaps similar in part to section 48 of the Act of 2008,²³ when Lord Herschell stated the common-law principle that a company²⁴ is not allowed to buy-back its own shares unless a buy-back is regulated in its constitution so as to allow for an *intra vires* act.²⁵ This "old" rule as stated by Lord Herschell required no true liquidity/solvency to legitimise the buy-back of shares. It required only an *intra vires* act to support or validate any buy back of shares, or else the transaction would be *ultra vires* and void in the common law.²⁶ Before it was amended in 1999, section 85 did not require an *intra vires* act to support or validate a buy-back of shares. On the other hand, section 75 required authorisation in the articles of association to decrease or increase the number of issued shares. If no authorisation was provided for in the articles of association, the decrease or increase constituted an *ultra vires* act. The same *intra vires* act is not *per se* a requirement in section 36(2) of the 2008 Act.²⁷ However, neither section 85 before it was amended (and after its amendment) nor section 75 seems to have been adequate in protecting the creditors of a company, since an *ultra vires* act could be set aside by the company in terms of section 36 of the 1973 Act.²⁸ In the 2008 Act, section 218 (2) simply states that any person who contravenes any provision of the 2008 Act is liable to any other person for any loss suffered, and section 218(1) continues that only a court has the power to declare an *ultra vires* act

²² *Trevor v Whitworth* 1887 12 AC 409 (HL); Pretorius *et al Company Law* (6th ed) 122; Benade *et al Entrepreneurial Law* 180.

²³ Briggs 1981 *De Rebus* 293; *Ex Parte Rietfontein Estates Ltd* 1976 1 SA 175 (W); Meskin *Henochsberg* (4th ed) 135. Before the Act was amended, s 83 regulated the reduction of share capital; Jooste 2007 *SALJ* 710; Yeats and Jooste 2009 *SALJ* 566.

²⁴ Cilliers *et al Corporate Law* para 190.01: the shareholders are a personification of the company, and are in reality the company; see Meskin *Henochsberg* (4th ed) 135.

²⁵ Also see *Cohen v Segal* 1970 3 SA 702 (W) 706.

²⁶ *Ex Parte NBSA Centre Ltd* 1987 2 SA 783 (T) 785. In this regard, s 311 of the *Companies Act* 61 of 1973 can be considered illegal in terms of reducing the share capital of the company through a buy-back of its own shares, unless so agreed by the members of the company. The consequence of an *ultra vires* act is that the buy-back is voided; Cassim 1998 *SA Merc LJ* 293; Cilliers *et al Corporate Law* para 12.14.

²⁷ Cassim 2005 *SALJ* 283.

²⁸ Meskin *Henochsberg* (5th ed) 179.

void or voidable. Consequently, the following paragraphs consider whether section 85 as was amended or its equivalent in section 4, in economic reality, indeed offers sufficient protection for creditors stemming from any buy-back of shares.²⁹

2.3 The new capital rules introduced in 2008 and the need for a reason as a requirement to legitimise a buy-back of shares

As stated above, the legal aspects of section 85 were not adequate to conclude whether the creditor or the company would be prejudiced due to a buy-back of shares,³⁰ as it was possible for management to "window-dress" the balance sheet.³¹ Irrespective of an *intra vires* act, the acquisition or buy-back depended on the balance sheet and whether the liquidity or solvency ratios had been met. Interestingly, the *Trevor* case³² considered a reason as an ancillary requirement to legitimise the acquisition or buy-back of shares. In that matter, Lord Herschell enquired as follows: "What was the reason which induced the company in the present case to purchase its shares?"³³

One such possible reason could be the prevention of a hostile takeover. Hostile takeovers have been covered in depth in law literature. The prevention of a hostile takeover relates more to the proper-purpose doctrine. For example, in the *Hogg v Cramphorn* case,³⁴ the board of directors issued additional shares in an attempt to avoid a hostile takeover, since the allotment of shares was not subject to any liquidity or solvency ratios. Although the directors believed that the allotment was in the best interest of the company (the creditors of the company were not

²⁹ See in general *Ex Parte Witwatersrand Board of Executors Building Society & Trust Co Ltd* 1926 WLD 205.

³⁰ Black, Wright and Davies *In Search of Shareholder Value* 23; Delpont *Verkryging van Kapitaal* 205.

³¹ Kilian and Du Plessis 2005 *TSAR* 48; Van der Linde 2009 *TSAR* 224.

³² *Trevor v Whitworth* 1887 12 AC 409 (HL); Pretorius *et al Company Law* (6th ed) 122; Benade *et al Entrepreneurial Law* 180.

³³ Pretorius *et al Company Law* (6th ed) 122.

³⁴ *Hogg v Cramphorn* 1967 Ch 254.

prejudiced), the court nevertheless held³⁵ that the additional allotment of shares was for an improper purpose.

This judgment concurs with that in the matter *Mills v Mills*,³⁶ where Chief Justice Latham held that:

... the question that arises is sometimes not a question of the interest of the company at all, but a question of what is fair between the different classes of shareholders ...³⁷

The reason for the latter statement is simply that, in economic reality, directors are also shareholders of a company, whose shares bear a direct relation to their own interests. Thus, if a director is advancing the interest of a company, he or she is also advancing his or her own interest in that company.³⁸ Through additional allotment, the earnings per share will decrease, which makes for an easy argument against the additional allotment of shares. Besides the latter, section 85 or section 48 requires no valid reason for such a buy-back, and whether or not a buy-back contravenes the proper-purpose doctrine falls outside the scope of this article.³⁹ However, it should be noted that any artificial increase in earnings per share to attract possible investors/shareholders should be interpreted as being improper.⁴⁰ Section 52 of the 2007 Bill also does not prohibit any artificial increase in earnings per share. It states the following:

Shares of a company that have been issued and subsequently re-acquired by that company, must be returned to the same status as shares of the same class that have been authorized but not issued.

³⁵ *Hogg v Cramphorn* 1967 Ch 254 265. Judge Buckley held that the majority of shareholders were acting oppressively towards the minority and/or that the powers of the directors interfered with the shareholders' rights as stipulated in the company's constitution.

³⁶ *Mills v Mills* 1938 60 CLR 150 (High Court of Australia).

³⁷ *Mills v Mills* 1938 60 CLR 150 (High Court of Australia) 162.

³⁸ *Mills v Mills* 1938 60 CLR 150 (High Court of Australia) 162-163.

³⁹ *Axiam Holdings v Deloitte & Touche* 2006 1 SA 237 (SCA); *Correia et al Financial Management* 512. The company's operations may create profit, but its future continuation depends on the availability of cash.

⁴⁰ Kilian and Du Plessis 2005 *TSAR* 48; *In Re X Ltd* 1982 2 SA 471 (W) 477; *Ex Parte Coca Cola (Pty) Ltd* 1947 3 SA 571 (T); *Ex Parte National Industrial Credit Corporation Ltd* 1950 2 SA 10 (W); Berelowitz 1979 *De Rebus* 199, 202. A skilful broker can realise shares without affecting their current listed price.

And the 2008 Act also does not prohibit any artificial increase in earnings per share. Section 35(5)(a) states:

Shares of a company that have been issued and subsequently acquired by that company, as contemplated in section 48, must have the same status as shares that have been authorized but not issued.

Similarly, section 48(3)(b) (which is equivalent to section 85) also contains the requirement of a plausible reason relating to the status of shares. A company in a relationship with a subsidiary may not purchase those shares if there would be no other shares than convertible or redeemable preference shares in the subsidiary. Section 48(5)(c) requires a genuine reason, and prohibits a buy-back if the end result of such an acquisition of shares would prevent the company from fulfilling its financial obligations - being unable to pay the creditors of the company timeously. It should be noted that section 48 does not explicitly refer to an *intra vires* act, but refers to the requirements of section 46 in the event of a buy-back. Section 46(1)(a) requires a legal obligation, which could imply the company's constitution.

In the following paragraphs, the focus shifts to the financial position of a company as a reason not to allow for a buy-back of shares or a decrease in the number of issued shares in terms of section 36(2).

3 Financial obligations

The equity or shareholders' fund is calculated by deducting liabilities from assets as disclosed in the balance sheet of the company. The book value of a share is determined by dividing the equity by the number of issued shares. This method is used for both par and no-par value shares in order to determine the book value of a company's shares,⁴¹ and can be illustrated as follows:

⁴¹ Marx *Investment Management* 131-151. There are five different methods to calculate the value of a share, and a specific method serves a purpose in a specific circumstance, ie for a business to be valued as a going concern or not.

Number of shares	Equity	Book value
100	R100	R1 per share *(100/100 = 1)

In the *Rabinowitz* case,⁴² the court used the book value and not the market price of the shares to determine their value. Although this may be correct, it should be noted here that the market price of a share is not a confirmation of the value of the company as a going concern,⁴³ but is merely used to calculate the current value of a listed share-capital company. This approach to calculating value is known as the market capitalisation of a listed company.⁴⁴ The following serves to illustrate this:

Number of shares	Market price per share	Market capitalisation (value of listed shares)
100	R0,50	R50 *(100 x .5 = 50)

However, the book value of a going concern is important, as it illustrates the relationship between the market price of a listed share and the book value per share, in other words, whether the market price of the share is overvalued or undervalued compared to the book value per share, as follows:

⁴² *Rabinowitz v Ned-Equity Insurance Co Ltd* 1980 1 SA 403 (W).

⁴³ *Donaldson Investments v Anglo-Transvaal Collieries* 1979 3 SA 713 (W) 731H-732B. The council's argument was that the net asset value or book value of shares is calculated as market cap (italisation). This is incorrect.

⁴⁴ See Berelowitz 1979 *De Rebus* 201.

Number of shares	Equity	Book value	Market cap
100	R10 000	R100 per share *(10 000/100 = 100)	R50 per share

If the shares are undervalued upon comparing the book value to the market cap,⁴⁵ this indicates grounds for a possible takeover bid, for example to acquire the company for R50 when the book value of its shares is R100 (see the table above). Similarly, if the book value is less than the market cap, it indicates that the price listed for the shares is overvalued. In order to increase the book value of the shares the board of directors will largely focus on reducing the company's debt or liabilities. As the debt decreases, the equity of the company will increase, since the amount of the liabilities deducted in the income statement will be less. Therefore, equity in the balance statement will increase. To illustrate this, the debt-to-equity ratio - which is also important to obtain a holistic view of the book value of shares - is used to spot artificial increases in earnings per share or book value per share.⁴⁶

Instead of altering the debt-to-equity ratio, for example by paying off the debt, the board of directors can use section 48 to alter the capital structure of the issued shares, and consequently artificially raise the issued shares' book value. Although capital or cash is required to fund the acquisition, this can easily be avoided by using section 36(2) of the 2008 *Companies Act*, which also alters the capital structure of

⁴⁵ The market cap is calculated as the number of issued shares multiplied by the listed price per share.

⁴⁶ Geyser and Liebenberg 2003 *Agrekon* 106. The authors recommend the shareholder value-added method as the performance measurement of an enterprise's value in the future. In Smit 2007 *TGW* 181, the author discusses why small- to medium-sized businesses fail in the commercial world, eg, because management does not undertake financial planning. The shareholder value-added or the economic value-added method indicates whether management is able to perform financial planning adequately, as it makes use of a forecast of current management decisions, linking these to business value. Also see *Donaldson Investments v Anglo-Transvaal Collieries* 1979 3 SA 713 (W) 731H-732B.

shares without any cash in return for shares.⁴⁷ Thus, section 36(2) is the focus of the following paragraph.

4 Altering the book value of shares without a buy-back

Section 75 of the 1973 *Companies Act* provides for altering the composition of the number of issued shares in relation to the share capital of the company.⁴⁸ Section 75(1) states as follows:

Subject to the provisions of sections 56 and 102 a company having a share capital, if so authorized by its articles, may by special resolution—

(c) consolidate and divide all or any part of its share capital into shares of larger amount than its existing shares or consolidate and reduce the number of the issued no par value shares;

(i) convert any of its shares, whether issued or not, into shares of another class.

Section 36(2) of the 2008 *Companies Act* states as follows:

The authorisation and classification of shares, number of authorised shares of each class and the preferences, rights, limitations and other terms associated with each class of shares, as set out in the company's memorandum of Incorporation, may be changed only by-

an amendment of the memorandum of incorporation by special resolution of the shareholders or the board of the company, in the manner contemplated in subsection 3 except to the extent that the memorandum of incorporation provides otherwise.

If the company has made use of section 36(2), the number of issued shares will be altered legally to "shares of larger amount", for instance 500 at R1 each converted into 250 at R2 each. To a potential investor, the result will indicate higher earnings per share (net profit divided by fewer shares),⁴⁹ producing a promising book value per share in the balance sheet.⁵⁰ The following table serves to illustrate this:

⁴⁷ *Companies Act* 61 of 1973.

⁴⁸ Cilliers *et al Corporate Law* 381.

⁴⁹ See Weaver and Keys *Mergers* 14.

⁵⁰ Walsh *Key Management Ratios* 170.

Number of shares	Equity	Book value
R1 x 500	R1 000	R2 per share *(1 000/500 = 2)
R2 X 250 *(s 75(1)(c))	R1 000	R4 per share *(1 000/250 = 4)

The above also applies to earnings per share. Equity increases through company profitability, as was discussed earlier and was illustrated by the debt-to-equity ratio. For example, if net profit is R1 000, earnings per share would be R4 per share (1 000/250). Compare this to 500 issued shares, which would work out to earnings per share of R2 per share (1 000/500). If a company is listed on the stock exchange and the listed price per share is R8, R8/R4 per share equals 2, compared to R8/R2 per share, which equals 4. In economic reality, the former simply is more investment-attractive.

Not only does section 36(2) influence the earnings-per-share ratio, but it affects other financial ratios as well. Section 36(2) can be utilised to alter the composition of the share capital of a company by converting certain shares into redeemable preference shares. Although the earnings-per-share ratio will be unchanged by the alteration, the return-on-equity ratio will be affected.⁵¹ Redeemable preference shares are excluded⁵² from the shareholders fund; therefore, without increasing the

⁵¹ Marx *Investment Management* 139; *Klein v Kalosus Holdings Ltd* 2003 SA 6 SA 198 (T), where the court dealt with a reduction in share capital; *Correia et al Financial Management* 205.

⁵² *Cilliers et al Korporatiewe Reg* 224, 337. The authors explain redeemable shares as a "... hibriede vorm van aandele en skuldbriewe met eienskappe van beide ... alhoewel hul suiwer as aandele beskou word". Also see SAICA *Earnings*.

net profits of a company, the return on equity will indicate a greater return, as follows:⁵³

Net profit	Equity	Return on equity
R100	R1 000	10% *(100/1 000 = 10)
R100	R500 (without redeemable pref. shares)	20% *(100/500=20)

This artificial method of altering the status of "shares" can convert any share-capital company into a company that is attractive to investors, by means of skilful financial engineering as permitted by section 36(2). Also, the 2008 *Companies Act* provides for the conversion of shares into other classes of shares in terms of section 41(3). Moreover, the 2008 Act and the 2007 Bill, in sections 36(3)(a) and 34(2)(a), also make provision for increasing or decreasing the number of shares. In essence, sections 36(3)(a) or 34(2)(a) allow for an artificial increase in earnings per share without complying with section 4 of the 2008 Act, as was discussed earlier.

The following represent some guidelines as to which companies should ideally be allowed to buy back shares, and which not. The same rationale should be applied to the use of section 36(2).

⁵³ Walsh *Key Management Ratios* 182. The stock market price of a share, divided by the book value of a share, must produce the same ratio when dividing the return on equity through the earnings yield.

5 Economic categories of companies

5.1 *A company experiencing fewer net profits than in previous financial years*

A company that experiences fewer retained profits along with increased liabilities will command less financial leverage to conduct business continuously,⁵⁴ and poses a greater risk of future liquidation or financial collapse.⁵⁵ Under such circumstances, a company should not be allowed to acquire its own shares.⁵⁶ See the following table as an illustration:

1998 financial year	1999 financial year
R10 net profit	R5 net profit
10 issued shares	10 issued shares, or buy back 5
Earnings per share are R1 *(10/10 = 1)	Earnings per share are R0,5 *(5/10 = .5) Earnings per share are R1 *(5/5 = 1) R1 is more investment-attractive

⁵⁴ Walsh *Key Management Ratios* 190. Increased liabilities can create increased profit as well as increased risk. The increase in liabilities should therefore increase the value of shareholders' equity at the same time. However, if the ratio/balance between debt and equity is increased beyond a prudent level - although this may indicate an increased earnings yield or a stronger return on equity - it will serve to reduce the total company or shareholders' value in the long term.

⁵⁵ Atkinson *Financial Collapse* 22; De Koker *Roekelose of Bedrieglike Dryf van Besigheid* 47; Vigarino *Managerial Accounting* 296.

⁵⁶ Donnan 1996 *C & SLJ* 101, which contains an interesting account of the business rules on share ratios.

	than R0,5. The R1 is called "artificial investment attractiveness".
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5.2 A company with a marginal or high growth rate

An increase or growth in the top line (the turnover) will increase the company's additional current assets (for example cash) with which to conduct business continuously.⁵⁷ It is therefore very important to understand in what way the company financed the increase (the growth) in turnover.⁵⁸ If the company did so by means of increased liabilities, its profitability may be negatively influenced if the anticipated increase in the top line is not achieved, resulting in a decrease in net profit. This would constitute a poor financial position like that in paragraph 5.1 above. On the other hand, marginal or high growth achieved through current assets will lead to net profits that are linear to the increase in the top line.

An increase in liabilities and a decrease in profitability will be an indication that the growth and profits are not in equilibrium and, consequently, the earnings per share will decrease. The board of directors must therefore adjust the growth rate of the company to yield favourable profitability results, as evidenced by the earnings-per-share ratio. Unless these circumstances are achieved, this type of company should also not be allowed to acquire its own shares as a method of artificially increasing the value of its shares.

⁵⁷ *Axiam Holdings v Deloitte & Touche* 2006 1 SA 237 (SCA); AASB 2005 http://www.aasb.co.au/pronouncements/aasb_standards_2005.htm; Dempsey and Pieters *Inleiding* 69 - "[w]inste is inkomste minus uitgawes"; Correia *et al Financial Management* 512 - the company's operations may create profit, but its future continuation depends on the availability of cash.

⁵⁸ Marx *Investment Management* 145; Walsh *Key Management Ratios* 122. To determine the cash-flow cycle, stock will be divided by the top line (sales), multiplied by 365 (ie expressed in days). The same approach will be used to determine days to the payment of accounts and account payments received. After calculating all the days, these must be added up and the accounts paid deducted, indicating the number of days on which there must be sufficient cash. This number of days divided by sales, multiplied by 365, as well as the predetermined growth in sales will express the amount of cash necessary to sustain the cash-flow cycle.

The following section serves to explain the concept of artificial increases in more detail, before it is illustrated with reference to a case law example.

6 Linearity between assets, profits and growth as a requirement to allow a buy-back of shares

6.1 The concept

Establishing whether assets, growth and net profit are in equilibrium, or linear to each other, requires a simple financial calculation or mere common sense.⁵⁹ For example, if the current assets (cash) are being used adequately to produce an increase or growth in the top line, the direct result should be an increase in net profits or equity reflected in a promising earnings-per-share ratio.

On the other hand, if a company increases its liabilities to finance a buy-back of its own shares, this will affect the profitability of the company negatively.⁶⁰ Under such circumstances there will be greater pressure on the current assets to increase not only the top line⁶¹ but to ensure that the additional liabilities deducted in the income statement will disclose favourable net profits. In an economic reality, the possibility arises that the current assets will not be sufficient to maintain previous profitability results owing to the additional burden of financing.

⁵⁹ Rappaport *Creating Shareholder Value* 18. The cost of equity is 12%. To illustrate the 12% in practice, consider the following: The turnover of a company is R200. An increase/growth of 10% will increase the turnover to R220 (R15 investment). If the company invested R30, sales/turnover must be increased by 20% in order to create equity value. If sales increased by only 10%, although earnings per share may be higher, the value of the equity is less. This is because the amount of cash invested is neither equal to the growth rate nor at least 20%.

⁶⁰ Marx *Investment Management* 133.

⁶¹ Pretorius *et al Company Law* (5th ed) 586, where the authors cite *Ammonia Soda Co Ltd v Chamberlain*, where the court in 1918 passed clear judgment on the importance of turnover (circulating capital) in relation to perpetual or everlasting existence. Since a company's focus is on circulating capital the intention is that the said capital be returned to the company at an increased (internal rate of return) rate - in other words, consisting of extra profits.

6.2 Case law example of non-linear assets, growth and profit

In the *Rosslare* case,⁶² the assets, growth and profit of the company must be assumed not to have been in balance, owing to the fact that the company had redeemed a liability through allotting additional shares. The asset concerned was a block of flats in which a member/shareholder could occupy a flat without paying rent. The plaintiff argued that the occupation of a flat was in fact a reduction of the capital of the company. The court held that this was not so.

It must be respectfully stated that the case seems to have been decided incorrectly. To illustrate why, the following liability example is again used. A liability places pressure on the top line/turnover of a company to produce sufficient net profits. If a liability is reduced, it follows that there will be increased net profits, evidenced by an increased earnings-per-share ratio.⁶³

Net profit before reducing the liability/loan	Net profit after reducing the liability/loan
R10	R11
Equity before loan is reduced	Equity after loan is reduced
R100	R150

⁶² *Rosslare v Registrar of Companies* 1972 2 SA 524 (D).

⁶³ Brews 1987 *S Afr J Bus Manag* 10; Donnan 1996 *C & SLJ* 101.

Return on equity before reducing the liability	Return on equity after reducing the liability
10%	7%
*(10/100 = 10)	*(11/150 = 7)

The increase in net profits stemming from the reduced liability will increase the earnings-per-share ratio.⁶⁴

Applying this logic to the case cited above, the occupation of a flat requires rent (growth) to be paid, and will consequently increase the top line linearly to net profits, which implies an increase in earnings per share. If rent is not paid, the asset or flat is not linear to the top line and, consequently, there is no increase in earnings per share. It is well understood that if rent is not paid, it dilutes the value of the lease agreement, and thus also the value of the shares of the company as a going concern.

Top line or turnover	Issued shares	Earnings per share	Net profit
R500 (rent not paid)	50	1 *(50/50 = 1)	R50
R620 (rent paid)	50	3.4 *(170/50 = 3.4)	R170

⁶⁴ Marx *Investment Management* 131.

From the table above, it is clear that the extra growth experienced in the top line as a direct result of the rental income indicates linearity between the rental income, growth and profitability through the earnings-per-share ratio. When rent is not paid, the number of issued shares (50) can be reduced to 15 to equal earnings per share similar to those if rent were paid - 50/15 equals 3.3 (3.4 in the above table) - by making use of section 36(2). For this reason, it is submitted that clever financial engineering should also be subject to section 4 or at least the giving of a reason as to why the company requires a decrease in the number of issued shares so as to avoid an artificial increase in earnings per share.⁶⁵

7 More case law: earnings per share and specific performance

In the *Haynes* case,⁶⁶ Judge De Villiers dealt with the matter of the court's discretion to grant an order for specific performance. There are certain principles affecting the court's discretion not to order specific performance if the same result could be achieved by ordering the payment of damages. A favourable economic reality may be achieved by ordering damages instead of specific performance.

In the *Benson* case,⁶⁷ however, the Appellate Division rejected the latter principle. In terms of the general principles of breach of contract, the innocent party has a right to elect either specific performance or damages.⁶⁸ The plaintiff in the *Benson* case purchased 171 500 shares, but received delivery of only 107 900. The plaintiff claimed specific performance of 63 600. The court granted the order on the basis of equity and in accordance with public policy.⁶⁹ If the court had applied the English-law principle as found in the *Haynes* case, the company that had failed to deliver the

⁶⁵ Pretorius *et al Company Law* (6th ed) 147. The auditors can also make use of tax returns to create higher apparent profits for a company. Tax returns differ from deferred tax on the basis of the delivery of money. Deferred tax is not money received by the company, because the Receiver of Revenue will debit the credit amount in the income statement. The reason behind this philosophy is that the company is a going concern.

⁶⁶ *Haynes v King William's Town Municipality* 1951 2 SA 371 (A) 378; Wessels 1920 SALJ 265.

⁶⁷ *Benson v SA Mutual Life Assurance Society* 1986 1 SA 776 (A). The *Benson* case also cited *Rex v Milne and Erleigh (7)* 1951 1 SA 791 (A) 873: "...[I]n contracts for the sale of shares which are daily dealt in on the market and can be obtained without difficulty, specific performance will not ordinarily be granted."

⁶⁸ Kerr *Law of Sale* 598; Kerr *Principles of Contract* 677.

⁶⁹ Pollard 1995 C & SLJ 353.

additional 63 600 shares would have increased its earnings per share, as these 63 600 would not have been taken into account when calculating earnings per share.⁷⁰

8 Conclusion

The *Companies Act* of 1973 did not make any provision for a maximum or minimum amount of capital required to float a company, or for a minimum number of shares to be issued.⁷¹ It is therefore possible for the promoters to excessively exercise their discretion when deciding on the authorised share capital, and later tailor-make (by buying back shares) or financially engineer the share capital structure in accordance with the business potential of the company, in order to generate an attractive earnings per share, especially in respect of listed companies.

This has not been altered by the *Companies Act* of 2008. Besides the latter statutory regulation, as was discussed earlier, it is consequently proposed that trafficking in shares (such as the buy-back of shares) must be prohibited if the purpose of a buy-back is to artificially increase the company's investment attractiveness.⁷² In addition, the buy-back of shares could easily be avoided by making use of section 36(2), which requires no solvency/liquidity ratios or any authorisation required in the memorandum of incorporation to amend the number of issued shares.⁷³ All that is required is a special resolution to amend the number of shares.

⁷⁰ Kerr *Law of Sale* 599; Ribstein 1992 *Nw U L Rev* 284.

⁷¹ The rules of the JSE require shares to be issued for at least R1 per share.

⁷² Berelowitz 1979 *De Rebus* 199, 202; Brews 1987 *S Afr J Bus Manag* 10.

⁷³ S 75 of the *Companies Act* 61 of 1973 required authorisation to amend the number of issued shares in the articles of association as well as a special resolution.

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LIST OF ABBREVIATIONS

AASB	Australian Accounting Standards Board
C & SLJ	Company and Securities Law Journal
NW U L Rev	Northwestern University Law Review
S Afr J Bus Manag	South African Journal of Business Management
SA Merc LJ	South African Mercantile Law Journal
SAICA	South African Institute of Chartered Accountants
SALJ	South African Law Journal
SEE	Journal for Studies in Economics and Econometrics
TGW	Tydskrif vir die Geesteswetenskappe
TSAR	Tydskrif vir die Suid-Afrikaanse Reg