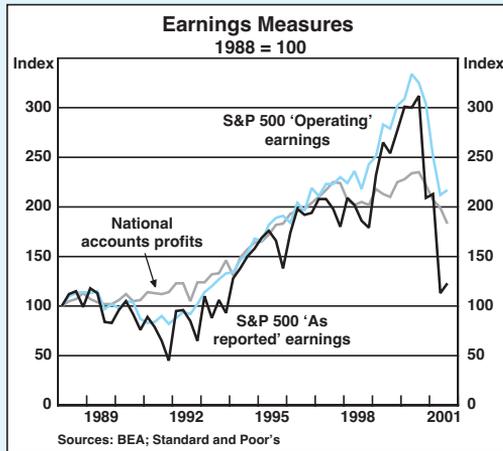


Box A: US Corporate Earnings

Interpretation of earnings data from US companies has become more difficult recently as different measures are showing quite wide divergences (Graph A1).

Graph A1



The National Accounting estimate of profits remains the best available, as it is consistent over time, and captures all profits earned by US companies. However, equity markets focus mainly on aggregate earnings for the companies in the S&P 500.

There are several ways in which S&P 500 earnings are reported. Historically the focus was on 'as reported' earnings, which includes all receipts less expenses, as defined by generally accepted accounting principles (GAAP). However, over recent years market analysts and companies have increasingly focused on 'operating' earnings (also known as 'pro forma' or 'as if' earnings). These are intended to adjust for special one-off items to give a clearer picture of ongoing profits. The problem, however, is that there are no official guidelines for what items can be added in or taken out, as 'operating' earnings is not a concept defined under GAAP. The *Wall Street Journal* has estimated that more than 300 companies in the S&P 500 now publish measures of operating earnings which fail to take full account of expenses,

which would be classified as ordinary expenses and hence subtracted from earnings calculated under GAAP.

Over 1999 and 2000, the S&P measures of earnings rose much faster than the National Accounts measure. An important reason for this is said to have been the practice of firms not including the cost of options granted to employees as an expense. The National Accounts adjusts for this. Also, throughout this time operating earnings remained higher than 'as reported' earnings.

More recently, the S&P measures have fallen sharply. In the year to the September quarter 2001, 'as reported' earnings of S&P 500 companies fell by 61 per cent and 'operating' earnings fell by 33 per cent. The National Accounts measure fell by 22 per cent over the same period.

The divergence in earnings reports has complicated the calculation and interpretation of traditional benchmarks of share valuation such as price earnings ratios. Historically, P/E ratios for the S&P 500 have been calculated by dividing the current level of share prices by the latest actual 12 months of 'as reported' earnings. Using this method, the P/E ratio for the S&P 500 has recently risen strongly, to around 40 – well above the historical average of around 14, and the highest level seen over the past century. Using the last 12 months of 'operating' earnings as the denominator, the S&P 500 P/E ratio is around 26. While this is below the P/E ratio calculated using 'as reported' earnings, it remains well above the historical average.

When valuing shares, it is future earnings which are most relevant. The aggregate P/E ratio for S&P 500 companies, based on estimates of the coming year's operating earnings, is 21. This is below the other measures, but still relatively high. The assumed rise in operating earnings in the coming year, which underlies this figure, is 36 per cent. This would require a very strong recovery in the US economy. ↗