

CHAPTER 17

EARNINGS PER SHARE

CHAPTER TOPICS CROSS REFERENCED WITH *CICA HANDBOOK*, PART I (IFRS) AND PART II (ASPE)

Earnings per Share	IAS 33	n/a
Financial Instruments—disclosure	IFRS 7	Section 3856
Financial Instruments—presentation	IAS 32	Section 3856

LEARNING OBJECTIVES

1. Understand why earnings per share (EPS) is an important number.
2. Understand when and how EPS must be presented.
3. Calculate earnings per share in a simple capital structure.
4. Calculate earnings per share in a complex capital structure.
5. Identify differences in the accounting standards between ASPE and IFRS, and what changes are expected in the future.

CHAPTER REVIEW

1. This chapter examines the issues related to earnings per share. The significance attached to the earnings per share (EPS) figure by shareholders and potential investors has caused the accounting profession to direct a great deal of attention to the calculation and presentation of EPS. The information is used in evaluating a company's profitability and value.
2. Other than non-public companies, most companies are required to report EPS information on the face of the income statement. Due to its importance, EPS must be reported on the face of the income statement. ASPE does not require EPS calculations or disclosures in the financial statements due to cost/benefit considerations and the fact that private enterprises are generally closely held.
3. When the income statement contains many components of income, the EPS numbers related to these other components may be disclosed on the face of the statement or in the notes. These will enable the financial statement users to recognize the effects of income from continuing operations on EPS, as separated from income or loss from irregular items, such as discontinued operations.
4. IFRS require that EPS amounts must be shown for all periods presented, and all prior period EPS presented should be restated for stock dividends and stock splits.
5. It is important to identify **potential** common shares. If the capital structure of the company consists only of common shares, or includes no potentially dilutive convertible securities, options, warrants, or other rights that upon conversion or exercise could in the aggregate dilute earnings per ordinary share, the company is said to have a **simple capital structure**. If a company has securities that could have a dilutive effect on EPS, then the company is said to have a **complex capital structure**.

$$\text{Earnings per share (EPS)} = \frac{\text{Net Income} - \text{Preference Dividends}}{\text{Weighted Average Number of Shares Outstanding}}$$

6. A **potential common share** is a type of security that may entitle its holder to a common share during or after the end of the reporting period (e.g., preferred shares).
7. Companies with simple capital structures need only calculate and present basic EPS, and those with complex capital structures must calculate and present both basic and diluted EPS.
8. If the **preferred shares are cumulative** and the dividend is not declared in the current year, an amount equal to the dividend that should have been declared for the current year only should be subtracted from net income or added to the net loss.
9. **Weighted average common shares** outstanding during the period includes the shares issued or purchased during the period, weighted by the fraction of the period during which they are outstanding.
10. **Stock dividends, splits, and reverse splits.** When stock dividends or stock splits occur, calculation of the weighted average number of shares requires restatement of the shares outstanding before the stock dividend or split (IAS 33.28).
11. If a stock dividend or stock split occurs after the end of the year but before the financial statements are issued, the weighted average number of shares outstanding for the year (and any other years presented in comparative form) must be restated.
12. **Mandatorily Convertible Instruments** — Where common shares will be issued in future due to mandatory conversion of a financial instrument that is already outstanding, it is assumed that the conversion has already taken place for EPS calculation purposes.
13. **Contingently issuable shares** are shares that are issuable for a very small consideration once a condition relating to uncertainty has been resolved. If these shares are issuable simply with the passage of time (as with the mandatorily convertible instruments noted above), they are not considered contingently issuable since it is certain that time will pass. Where they are issuable based on something else (for example, profit levels or performance targets), they are included in the calculation of basic EPS when the conditions are satisfied.

Computing Earnings per Share

1. As noted above, **earnings per share** must be disclosed in the income statement or a note thereto. This requirement applies to entities classified as a public enterprise.
2. **In all computations of earnings per share, the weighted average of shares outstanding during the period constitutes the basis for the per share amounts reported.** In computing the weighted average of shares outstanding, shares issued or retired during the period are weighted by the fraction of the period during which they were outstanding. These amounts are then added to the number of shares outstanding for the entire period. **Stock dividends and stock splits that occur during the period require restatement of the shares outstanding prior to the stock dividend or split.**

Simple Capital Structure

1. A **simple capital structure** is one that consists only of common shares or includes no potential common shares. A potential common share is a security or other contract that upon conversion or exercise could dilute earnings per common share. If a simple capital structure exists, the computation of EPS is simply the net income reported for the period (less any preferred dividends) divided by the weighted average number of actual shares outstanding during the period.
2. **Calculating EPS in a simple capital structure.** Income available to common shareholders is equal to net income less amounts to preferred shareholders.

Complex Capital Structure

1. A capital structure is said to be **complex** if it includes securities that could have a dilutive effect on earnings per common share. A complex capital structure requires a **dual presentation** of earnings per share. This dual presentation consists of **basic earnings per share** and **diluted earnings per share**.

Basic Earnings per Share

1. Basic EPS is based on the number of common shares outstanding. Basic EPS must be computed and reported separately for each class of common shares outstanding.

2. Basic EPS is calculated as the net income for the period divided by the weighted average number of shares outstanding during the period. When a company has both preferred and common equity instruments outstanding, the preferred **dividends for the current year are subtracted from net income** to arrive at **income available to common shareholders**. If dividends on preferred shares are declared and a net loss occurs, the **preferred dividend is added to net loss** for purposes of computing the loss per share.

Diluted Earnings per Share

1. The purpose of reporting **diluted earnings per share** is to disclose the **maximum possible reduction in EPS that could take place if all qualifying issuable common shares were issued**. This calculation requires the determination of the weighted average number of common shares issuable and the related "income effect" of the various issuance possibilities. All dilutive securities must be considered when determining whether diluted earnings per share should be reported.
2. The method used to measure the dilutive effects of potential conversion on EPS is called the **if-converted method**. This method assumes:
 - a. The conversion of the convertible securities at the beginning of the period, and
 - b. The elimination of interest (net of tax).

Thus, the denominator—the weighted average number of shares outstanding—is increased by the additional shares issued. The numerator—net income—is increased by the amount of interest expense, net of tax, associated with those potential common shares.

3. Stock options and warrants outstanding, whether or not currently exercisable, are included in diluted EPS unless they are antidilutive. The **treasury stock method** assumes that the options or warrants are exercised at the beginning of the year (or the date of issue if later) and the proceeds from the exercise of options and warrants are used to purchase common shares from the treasury. For both options and warrants, **exercise is not assumed unless the average market price of the shares is above the exercise price** during the period being reported.

4. Complex capital structures require dual presentation of basic and diluted EPS. Per share amounts should be shown for:
 - a. income from continuing operations,
 - b. net income,
 - c. discontinued items, where applicable (may also be presented in the notes to the financial statements)

5. **Antidilutive securities** are securities that would create an increase in EPS (or a reduction in net loss per share). **Any antidilutive security should be excluded from the computation of diluted earnings per share.** If the securities are antidilutive, the likelihood of conversion or exercise is considered remote. Companies that have only antidilutive securities are not permitted to increase EPS and are required to report only basic EPS.

6. **Treasury Stock Method.** Calculate diluted EPS using the treasury stock method. Written options and warrants and their equivalents are included in EPS calculations through the treasury stock or reverse treasury stock method.

7. **The treasury stock method** is applied to written call options and equivalents and assumes (a) that the options and warrants or equivalents are exercised at the beginning of the year or date of issue if later, and (b) that the proceeds are used to purchase common shares for the treasury shares at the average market price.

8. To illustrate the treasury share method, assume 2,000 options are outstanding with an exercise price of \$25 per ordinary share. If the market price of the ordinary shares is \$60 per share, computation of the incremental shares using the treasury share method would be:

Proceeds from exercise of 2,000 options	
(2,000 × \$25).....	<u>\$50,000</u>
Shares issued upon exercise of options.....	2,000
Treasury shares purchasable with proceeds (\$50,000/\$60).....	<u>(833)</u>
Incremental shares outstanding (potential ordinary shares).....	<u>1,167</u>

9. **The reverse treasury stock method** is used for written put options and forward purchase contracts, and it assumes (a) that the company will issue sufficient common shares at the beginning of the year in the marketplace to generate funds to buy the shares under option/forward, and (b) that the proceeds from the above will be used to buy back the shares under option/forward at the beginning of the year.
10. **Contingently issuable shares** are potential common shares. If the shares are issuable upon the mere passage of time, they are not considered contingently issuable because of time certainty.
11. **Antidilutive potential common shares** are securities whose inclusion in EPS calculations would increase earnings per share or reduce net loss per share. Convertible debt is antidilutive if the addition to income of the interest net of tax causes a greater percentage increase in income (i.e., numerator) than the conversion of the bonds causes a percentage increase in common and potentially dilutive shares (i.e., denominator). Antidilutive potential common shares are irrelevant since they result in more diluted EPS calculations than the basic EPS, and that is why these numbers are antidilutive.
12. Additional Disclosure is required in note form for complex capital structures and a dual presentation of earnings as follows:
 - The amounts used in the numerator and denominator in calculating basic and diluted EPS
 - A reconciliation of the numerators and denominators of basic and diluted per share calculations for income before discontinued operations
 - Securities that could dilute basic EPS in the future but were not included in the calculation because they have antidilutive features
 - A description of common share transactions that occur after the reporting period that would have significantly changed the EPS numbers.

IFRS/ASPE Comparisons

1. Earnings per share is one of the most frequently used standards of measurement for assessing management stewardship and predicting a company's future value.
2. Diluted EPS is particularly useful if there are many convertible securities, options and warrants, and other financial instruments. Shareholders need to know how these instruments can affect their investments and IASB is developing standards to ensure greater transparency in EPS calculations and disclosures.
3. Standards are basically converged except that ASPE does not prescribe standards for calculating EPS at all. EPS standards therefore only apply to publicly accountable entities in Canada.