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Chapter 16 IAS 33 EPS

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IAS 33 Earning per share

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IAS 33 Earning per share

Basic EPS

IAS 33 Earning per share

- Earnings per share is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preference dividends.

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EPS should be calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by **the weighted average number of ordinary shares** outstanding during the period.

$$\text{Basic EPS} = \frac{\text{Net profit/(loss)attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

Example: weighted average number of shares

Justina Co, a listed company, has the following share transactions during 20X7.

Date	*Details*	*Shares issued*
1 January 20X7	Balance at beginning of year	170,000
31 May 20X7	Issue of new shares for cash	80,000
31 December 20X7	Balance at year end	250,000

Required

Calculate the weighted average number of shares outstanding for 20X7.

Solution

The weighted average number of shares can be calculated in two ways.

(a) $(170{,}000 \times 5/12) + (250{,}000 \times 7/12) = 216{,}666$ shares

(b) $(170{,}000 \times 12/12) + (80{,}000 \times 7/12) = 216{,}666$ shares

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Flame Co is a company with a called up and paid up capital of 100,000 ordinary shares of $1 each and 20,000 10% redeemable preference shares of $1 each.

The gross profit was $200,000 and trading expenses were $50,000. Flame Co paid the required preference share dividend and an ordinary dividend of 42c per share. The tax charge for the year was estimated at $40,000.

Calculate basic EPS for the year.

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Gross profit	200,000
Expense (50,000+20,000*10%)	(2,000)
Profit before tax	148,000
Income tax	(40,000)
Profit for the year	108,000

$$EPS = \frac{\$108,000}{100,000}$$

Bonus issue and right issue

Rights issue

A rights issue of shares is **an issue of new shares to existing shareholders at a price below the current market value.** The offer of new shares is made on the basis of x new shares for every y shares currently held; eg a 1 for 3 rights issue is an offer of one new share at the offer price for every three shares currently held. This means that there is a bonus element included.

To arrive at figures for EPS when a rights issue is made, we need to calculate first of all the theoretical ex-rights price. This is a weighted average value per share, and is perhaps explained most easily with a numerical example.

Theoretical ex-rights price

Suppose that Egghead Co has 10,000,000 shares in issue. It now proposes to make a 1 for 4 rights issue at a price of $3 per share. The market value of existing shares on the final day before the issue is made is $3.50 (this is the 'with rights' value). What is the theoretical ex-rights value per share?

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Before issue 4 shares, value $3.50 each	14.00
Rights issue 1 share, value $3	3.00
Theoretical value of 5 shares	17.00

$$\text{Theoretical ex-rights value} = \frac{\$17.00}{5} = \$3.40 \text{ per share}$$

Bonus issue

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Greymatter Co had 400,000 shares in issue, until on 30 September 20X2 it made a bonus issue of 100,000 shares. Calculate the EPS for 20X2 and the corresponding figure for 20X1 if total earnings were $80,000 in 20X2 and EPS for 20X1 was 18.75c. The company's accounting year runs from 1 January to 31 December.

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	20X2	
Earnings	$80,000	
Shares at 1 January	400,000	
Bonus issue	100,000	
	500,000	shares
EPS	16c	

The number of shares for 20X1 must also be adjusted if the figures for EPS are to remain comparable.

The EPS for 20X1 is therefore restated as:

$$18.75c \times \frac{400}{500} = 15c$$

Diluted EPS

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Diluted EPS is calculated by adjusting the net profit due to continuing operations attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

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At the end of an accounting period, a company may have in issue some securities which do not (at present) have any 'claim' to a share of equity earnings, but may give rise to such a claim in the future.

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These securities include:

- a)A separate class of equity shares which at present is not entitled to any dividend, but will be entitled after some future date
- b)Convertible loan stock or convertible preferred shares which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
- c)Options or warrants

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- In such circumstances, the future number of ordinary shares in issue might increase, which in turn results in a fall in the EPS. In other words, a future increase in the number of ordinary shares will cause a dilution or 'watering down' of equity, and it is possible to calculate a diluted earnings per share (ie the EPS that would have been obtained during the financial period if the dilution had already taken place). This will indicate to investors the possible effects of a future dilution.

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In 20X7 Farrah Co had a basic EPS of 105c based on earnings of $105,000 and 100,000 ordinary $1 shares. It also had in issue $40,000 15% convertible loan stock which is convertible in two years' time at the rate of 4 ordinary shares for every $5 of stock. The rate of tax is 30%.

Required

Calculate the diluted EPS.

IAS 33 Earning per share

Diluted EPS is calculated as follows.

Step 1 **Number of shares**: the additional equity on conversion of the loan stock will be 40,000 × 4/5 = 32,000 shares.

Step 2 **Earnings**: Farrah Co will save interest payments of $6,000 (40,000 × 15%) but this increase in profits will be taxed. Hence the earnings figure may be recalculated:

(105,000 + (6,000 × 70%)) = $109,200

Step 3 **Calculation**: Diluted EPS = $\frac{\$109,200}{132,000}$ = 82.7c

Step 4 **Dilution**: the dilution in earnings would be 105c – 82.7c = 22.3c per share.

IAS 33 Earning per share

Ardent Co has 5,000,000 ordinary shares of 25 cents each in issue, and also had in issue in 20X4:

(a) $1,000,000 of 14% convertible loan stock, convertible in three years' time at the rate of two shares per $10 of stock

(b) $2,000,000 of 10% convertible loan stock, convertible in one year's time at the rate of three shares per $5 of stock

The total earnings in 20X4 were $1,750,000.

The rate of income tax is 35%.

Required

- Calculate the basic EPS and diluted EPS.

IAS 33 Earning per share

(a) Basic EPS = $\frac{\$1{,}750{,}000}{5 \text{ million}}$ = 35 cents

(b) We must decide which of the potential ordinary shares (ie the loan stocks) are dilutive (ie would decrease the EPS if converted).

For the 14% loan stock, incremental EPS = $\frac{0.65 \times \$140{,}000}{200{,}000 \text{ shares}}$ = 45.5c

For the 10% loan stock, incremental EPS = $\frac{0.65 \times \$200{,}000}{1.2\text{m shares}}$ = 10.8c

The effect of converting the 14% loan stock is therefore to **increase** the EPS figure, since the incremental EPS of 45.5c is greater than the basic EPS of 35c. The 14% loan stock is not dilutive and is therefore excluded from the diluted EPS calculation.

The 10% loan stock is dilutive.

Diluted EPS = $\frac{\$1.75\text{m} + \$0.13\text{m}}{5\text{m} + 1.2\text{m}}$ = 30.3c

Presentation, disclosure and other matters

IAS 33 Earning per share

An entity should disclose the following.

(a) The amounts used as the **numerators** in calculating basic and diluted EPS, and a **reconciliation** of those amounts to the net profit or loss for the period

(b) The weighted average number of ordinary shares used as the **denominator** in calculating basic and diluted EPS, and a **reconciliation** of these denominators to each other

Significance of earnings per share

Earnings per share (EPS) is one of the most frequently quoted statistics in financial analysis. Because of the widespread use of the price earnings **(P/E) ratio** as a yardstick for investment decisions, it became increasingly important. It is certainly true that EPS gives a more accurate picture of the actual return to investors than reported profits, which do not show the dilutive effect of share issues.

IAS 33 Earning per share

Reported and forecast EPS can, through the P/E ratio, have a **significant effect on a company's share price**. Thus, a share price might fall if it looks as if EPS is going to be low.

There are a number of reasons why EPS should **not** be used to determine the value of a company's shares. IAS 33 concentrates on the **denominator** of EPS – ie the number of shares. However, it is more difficult to regulate the **numerator** – earnings. Reported earnings can be affected by a number or factors – choice of accounting policy, asset valuation, taxation issues. Directors who want to present favourable EPS can find ways to boost reported earnings, as happened with Enron.

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Thank You!