

## Earnings Per Share

# Understanding Earnings Per Share (EPS): Authoritative Guidance and Core Concepts

Earnings Per Share (EPS) is a crucial financial metric that provides a standardized measure of a company's profitability allocated to each outstanding common share. It is a key indicator used by investors and analysts to evaluate company performance, forecast future earnings, and estimate share value. The higher the EPS, the more profitable the company is considered, and the more profits are available for distribution to its shareholders.

The authoritative guidance for calculating, presenting, and disclosing EPS under U.S. Generally Accepted Accounting Principles (GAAP) is primarily found in **FASB Accounting Standards Codification (ASC) Topic 260, Earnings Per Share**. This guidance applies to all entities that have issued common stock or potential common stock that trades publicly, or entities in the process of filing with a regulatory agency for a public sale of securities. While presentation of EPS is not required for nonpublic entities or investment companies within the scope of ASC 946, any entity that voluntarily chooses to present EPS must do so in accordance with ASC 260.

There are two main types of EPS required to be reported: **Basic EPS** and **Diluted EPS**. Basic EPS aims to measure a company's performance over a reporting period, while Diluted EPS measures performance while accounting for all potentially dilutive common shares outstanding. Diluted EPS is required to prevent management from misleading shareholders about profitability by issuing convertible securities that don't immediately require common shares but could lead to their issuance in the future.

## Basic EPS: Calculation and Components

**Basic EPS** represents the amount of earnings available to each share of common stock outstanding during the reporting period.

**Calculation for Basic EPS:** The formula for basic EPS is: **Basic EPS = (Income Available to Common Stockholders) / (Weighted-Average Number of Common Shares Outstanding)**

1. **Numerator: Income Available to Common Stockholders** This component starts with **net income (or loss)** attributable to the parent entity. Several adjustments are then made to arrive at the amount of income truly available to common shareholders:
  - **Preferred Stock Dividends:** Dividends declared on preferred stock (whether paid or not) and dividends accumulated on cumulative preferred stock (whether earned or not) must be deducted from net income.
    - For **cumulative preferred shares**, the preferred shareholder's entitlement must always be deducted, irrespective of whether they are declared or paid, and only the current period's dividends are considered, not any dividends in arrears.

- For **non-cumulative preferred shares**, dividends are only deducted if they have been declared.
    - If an entity has a loss from continuing operations or a net loss, the amount of the loss is *increased* by these preferred dividends.
  - **Noncontrolling Interests:** Income (or loss) attributable to noncontrolling interests in subsidiaries is excluded from income available to common stockholders for consolidated financial statements.
  - **Redeemable Securities and Down Round Features:** Adjustments may also be required for the effects of redemption or induced conversion of preferred stock, changes in the carrying amount of certain redeemable securities, and the value of triggering a down round feature in an equity-classified instrument. Specifically, if a down round feature is triggered in an equity-classified freestanding financial instrument or convertible preferred stock, its value is treated as a dividend and reduces income available to common stockholders in basic EPS.
  - **Redeemable Common Stock:** For common stock redeemable at other than fair value, increases or decreases in its carrying amount are reflected in EPS using a method similar to the two-class method. However, if common stock is redeemable at fair value, it does not affect EPS.
2. **Denominator: Weighted-Average Number of Common Shares Outstanding** This is the average number of common shares outstanding during the reporting period, weighted for the portion of the period they were outstanding. Shares issued or reacquired during the period are weighted accordingly. The most precise average involves summing daily shares and dividing by the number of days, but less precise methods yielding reasonable results are acceptable.

#### **Securities Excluded from Basic EPS Denominator:**

- **Options, Warrants, and Equivalents:** These are generally excluded from basic EPS calculations.
- **Nonvested Share-Based Payment Awards:** These are typically not included in basic EPS, even if legally outstanding, unless they are participating securities with nonforfeitable dividends.
- **Convertible Securities:** These are excluded from the basic EPS calculation.
- **Contingently Issuable Shares:** Shares that can be issued for little or no cash upon satisfying certain conditions are included in basic EPS only **as of the date that all necessary conditions have been satisfied**, meaning their issuance is no longer contingent (except for the passage of time). Shares that are contingently returnable (subject to recall) are treated similarly.

### **Diluted EPS: Calculation and Methods for Dilutive Securities**

**Diluted EPS** is a more conservative measure that accounts for the potential reduction in EPS if all dilutive securities were converted into common shares. Dilution is a reduction in EPS resulting from the assumption that convertible securities were converted, or options/warrants were exercised, or other shares were issued upon satisfying certain conditions.

**Calculation for Diluted EPS:** The computation of diluted EPS is similar to basic EPS, but the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. Adjustments to the numerator may also be necessary.

### **Key Principles for Diluted EPS:**

- **Antidilution Principle:** Only **dilutive** potential common shares (those that reduce EPS or increase loss per share) are included in the diluted EPS calculation. Securities that would have an antidilutive effect are excluded.
  - If an entity has a **loss from continuing operations** (or a loss from continuing operations available to common stockholders after preferred dividend deductions), diluted EPS is computed in the same way as basic EPS. This is because including potential common shares in a loss scenario would generally be antidilutive (i.e., it would *increase* the loss per share, which is considered antidilutive). The "control number" for determining dilutive vs. antidilutive is **income from continuing operations**.
- **Antidilution Sequencing:** To reflect maximum potential dilution, each issue or series of issues of potential common shares is considered **separately** and in sequence from the **most dilutive to the least dilutive**. Dilutive potential common shares with the lowest earnings per incremental share are included first. Options and warrants are typically included first because their exercise does not usually affect the numerator of the EPS computation.
- **Most Advantageous Rate:** Diluted EPS should be based on the conversion rate or exercise price that is **most advantageous from the security holder's standpoint**.
- **Average Market Price:** After the adoption of ASU 2020-06, entities are generally required to use the **average market price** to calculate the diluted EPS denominator if the number of potential common shares is variable.

### **Treasury Stock Method (for Options, Warrants, and Equivalents)**

The **treasury stock method** is used to compute the dilutive effect of **options, warrants, and their equivalents** (e.g., nonvested share-based payment awards, stock purchase contracts, partially paid stock subscriptions that don't share in dividends).

#### **How it works:**

1. It is assumed that options and warrants are **exercised at the beginning of the period** (or at the time of issuance, if later), leading to the issuance of common shares.
2. The **proceeds** received from this assumed exercise are then assumed to be used by the company to **repurchase common stock in the market at the average market price** during the period.
3. The **incremental shares** (the difference between the shares assumed issued and the shares assumed repurchased) are **added to the denominator** of the diluted EPS calculation.

4. Generally, the **numerator is not adjusted** under the treasury stock method, except in specific cases related to down round features or certain cash/share settled contracts.

**Dilutive Condition:** Options and warrants only have a dilutive effect under the treasury stock method when the **average market price of the common stock during the period exceeds the exercise price** (i.e., they are "in the money"). If they are "out-of-the-money," they are typically excluded as antidilutive.

### **If-Converted Method (for Convertible Securities)**

The **if-converted method** is used to reflect the dilutive effect of **convertible securities** (e.g., convertible bonds, convertible preferred shares). With the adoption of ASU 2020-06, entities are now required to use the if-converted method for **all convertible instruments**.

#### **How it works:**

1. It is assumed that **convertible securities were converted into common stock at the beginning of the period** (or at the time of issuance, if later).
2. **Numerator Adjustment:**
  - For **convertible preferred stock**, the **preferred dividends applicable to the convertible preferred stock are added back** to the numerator (income available to common stockholders). This is because if the preferred stock converted, those dividends would not have been paid.
  - For **convertible debt**, the **interest (net of tax and nondiscretionary adjustments) on the convertible debt is added back** to the numerator. This adjustment reflects that interest expense would not have been incurred if the debt had converted.
    - Notably, after ASU 2020-06, for convertible debt where the principal is required to be paid in cash upon conversion, interest charges on the principal portion are *not* added back to the numerator.
3. **Denominator Adjustment:** The **common shares that would have been issued upon conversion** are added to the weighted-average number of common shares outstanding.

**Dilutive Condition:** Convertible securities are dilutive if the preferred dividends (or interest, net of tax) per common share obtainable upon conversion is **less than basic EPS**. If it is higher, the conversion is considered antidilutive, and the securities are not included.

### **Presentation and Disclosure Requirements**

EPS data must be presented for **every period for which a statement of operations is presented**.

- **Simple Capital Structures:** Entities with only common stock outstanding (no potentially dilutive securities) are required to present **basic per-share amounts** for both "income from continuing operations" and "net income" on the face of the income statement.

- **Complex Capital Structures:** All other entities (those with potentially dilutive securities) are required to present **both basic and diluted per-share amounts** for "income from continuing operations" and "net income" on the face of the income statement, with equal prominence.
  - If diluted EPS is presented for any period, it must be presented for **all periods shown**, even if it is the same amount as basic EPS.
  - The terms "basic" and "diluted" are not strictly required; alternative terms like "earnings per common share" and "earnings per share — assuming dilution" can be used.
- **Discontinued Operations:** Entities reporting discontinued operations must present basic and diluted per-share amounts for that line item either on the face of the income statement or in the notes to the financial statements.
- **No Cash Flow Per Share:** Reporting an amount of cash flow per share is prohibited.

**Required Disclosures:** For each period an income statement is presented, entities must disclose:

- A **reconciliation of the numerators and denominators** of the basic and diluted EPS computations for income from continuing operations, including the individual income and share effects of all securities.
- The **effect of preferred dividends** in arriving at income available to common stockholders for basic EPS.
- **Securities not included in diluted EPS** because they were antidilutive for the period(s) presented (e.g., "out-of-the-money" options), along with full disclosure of their terms and conditions.
- The **methods used** in the diluted EPS computation for each type of dilutive instrument (e.g., treasury stock method, if-converted method, two-class method, or reverse treasury stock method).

EPS disclosures are mandatory for companies with shares traded in a public market. This comprehensive reporting ensures transparency regarding a company's earning capability and its potential dilution, providing investors with essential information for informed decision-making.