



EPS

Back-to-basics refresher

May 13, 2020



Introductions



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Agenda

Scope

Basic EPS

Diluted EPS

Participating securities and the two-class method

Retrospective adjustments

EPS in interim financial statements

Presentation and disclosure



Polling question #1



Does your company have multiple instruments to consider for diluted EPS?

- Yes
- No
- N/A



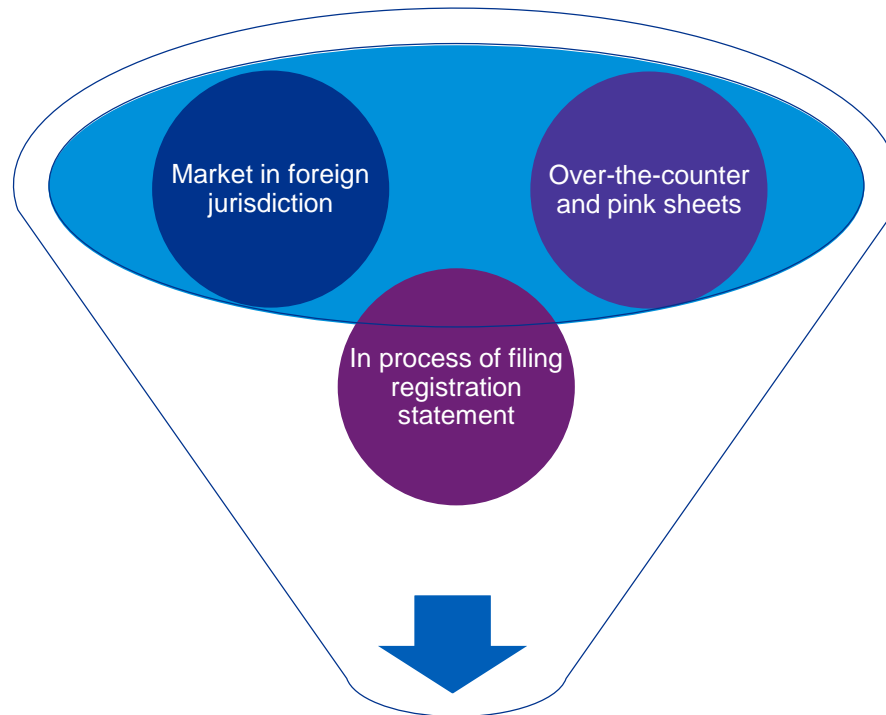


Scope

Scope of Topic 260

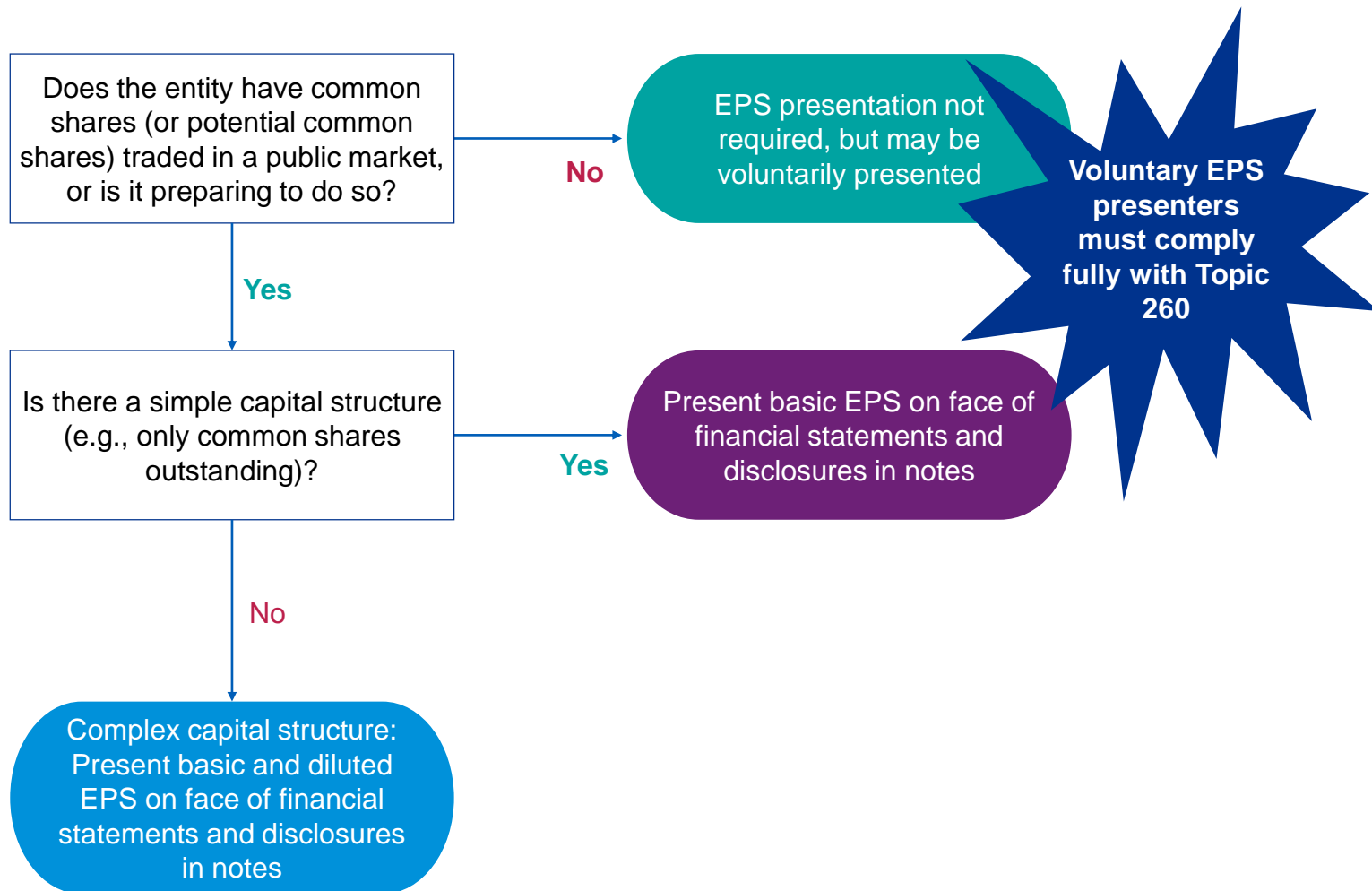
All entities that have issued

- **common shares** or other securities that are **potential common shares**, if...
- the securities trade in a **public market**.



Topic 260 includes specific guidance for Master Limited Partnerships (MLPs).

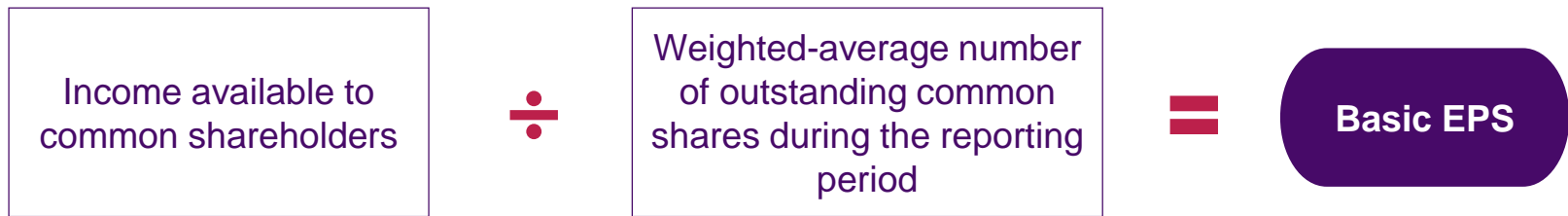
What EPS to present?





Basic EPS

Basic EPS calculation



Step 1

Three-step approach to basic EPS

1

Determine the income available to common shareholders for the reporting period (the numerator)

2

Determine the weighted-average number of outstanding common shares for the reporting period (the denominator)

3

Determine basic EPS

Income available to common shareholders

Step 1: Determine the numerator

Income (loss) from continuing operations, adjusted for:

Returns on **equity**-classified preferred shares

Returns on participating **equity** instruments and other classes of common shares

Obligation to cover NCI losses

Returns on equity-classified preferred shares

What is included?

Dividends on noncumulative preferred shares declared in the period

+

Dividends on cumulative preferred shares earned during the period, whether declared or not

+/-

Amortization of any original issue discount (premium) on increasing rate preferred shares

+/-

Any differences on settlement

Numerator example

ABC Corp. has 500,000 equity-classified preferred shares outstanding throughout the year.

- Each preferred share is entitled to a cumulative dividend of \$1.20, but it has no further rights to participate in dividends with common shares.
- Net income for Year 1 is \$4,600,000.

Determine the numerator

Net income	\$4,600,000
Returns to equity-classified preferred shares:	
Cumulative preferred dividends [500,000 × \$1.20]	<u>(600,000)</u>
Income available to common shareholders of ABC	<u>\$4,000,000</u>

Step 2

Three-step approach to basic EPS

1

Determine the income available to common shareholders for the reporting period (the numerator)

2

Determine the weighted-average number of outstanding common shares for the reporting period (the denominator)

3

Determine basic EPS

Denominator example

ABC Corp. has the following capital structure:

Dates in Year 1	Transaction	Common shares
January 1	Balance	1,000,000
July 1	Common shares issued for cash	500,000
September 1	Common shares issued for cash	500,000
December 31	Balance	<u>2,000,000</u>

ABC calculates the weighted-average number of outstanding common shares for Year 1 as follows:

	Number of shares outstanding	Time weighting	Weighted-average number of shares
January 1 to June 30	1,000,000	6/12	500,000
July 1 – shares issued	500,000		
July 1 to August 31	1,500,000	2/12	250,000
September 1 – shares issued	500,000		
September 1 to December 31	<u>2,000,000</u>	4/12	666,667
		<u>12/12</u>	
Weighted-average number of shares outstanding			<u>1,416,667</u>

Step 3

Three-step approach to basic EPS

1

Determine the income available to common shareholders for the reporting period (the numerator)

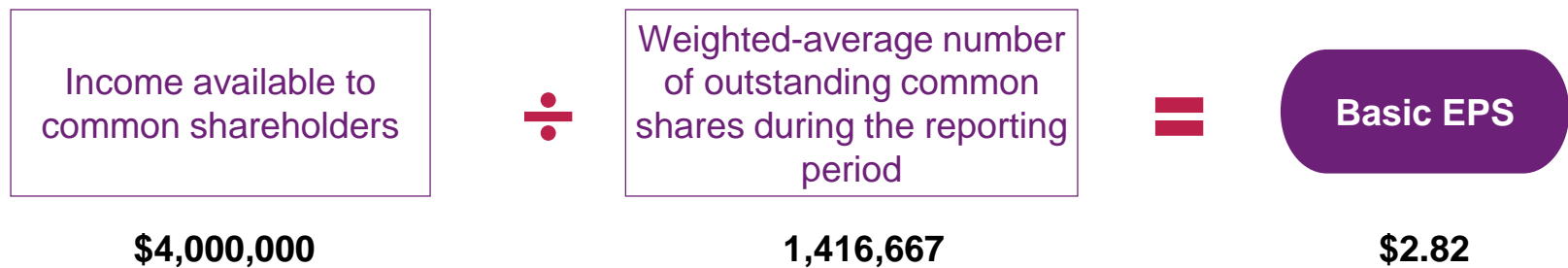
2

Determine the weighted-average number of outstanding common shares for the reporting period (the denominator)

3

Determine basic EPS

Basic EPS calculation



Polling question #2



Which of the following is *not* adjusted for when calculating the numerator for basic EPS?

- a. Declared dividends on equity-classified preferred shares
- b. Cumulative dividends on equity-classified preferred shares
- c. Dividends on liability-classified preferred shares
- d. Amortization of premium on equity-classified preferred shares



Polling question #2



Which of the following is *not* adjusted for when calculating the numerator for basic EPS?

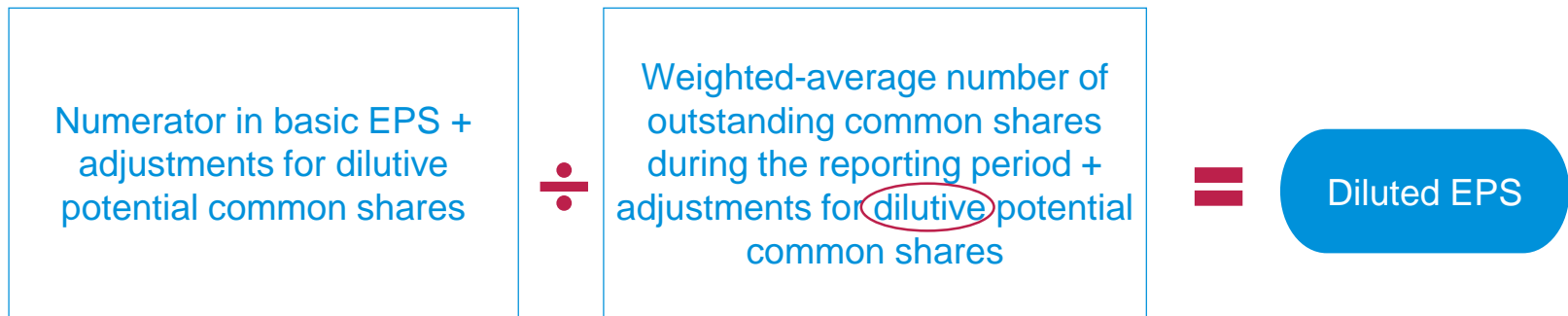
- a. Declared dividends on equity-classified preferred shares
- b. Cumulative dividends on equity-classified preferred shares
- c. Dividends on liability-classified preferred shares
- d. Amortization of premium on equity-classified preferred shares





Diluted EPS

Components of diluted EPS



Step 1

Five-step approach to diluted EPS

1

Identify potential common shares

2

For each potential common share, determine EPIS

3

Rank potential common shares based on EPIS

4

Determine basic EPS from continuing operations

Determine
control number

5

Identify dilutive potential common shares and determine diluted EPS

Types of potential common shares

Unvested shares

Options, warrants and their
equivalents

Contingently issuable
common shares

Convertible instruments

Written puts

Others

Step 2

Five-step approach to diluted EPS

1

Identify potential common shares

2

For each potential common share, determine EPIS

3

Rank potential common shares based on EPIS

4

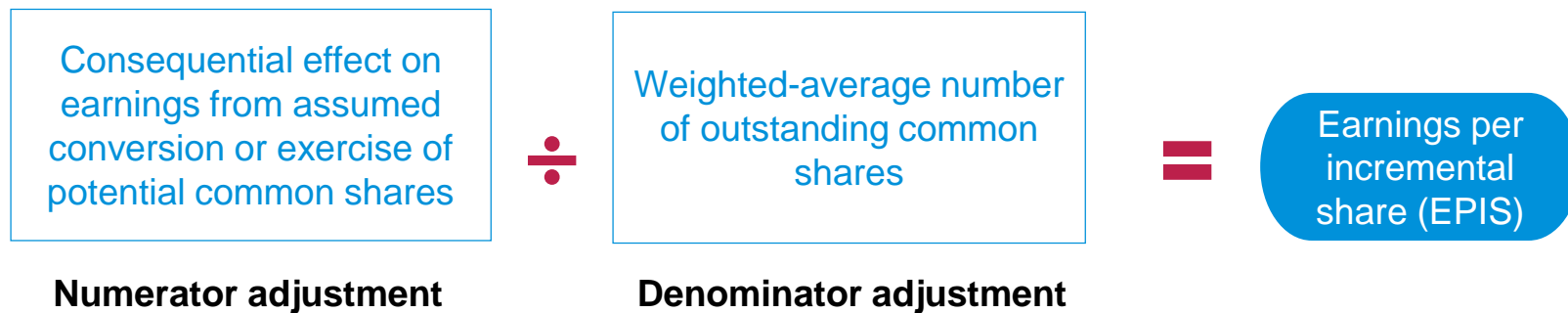
Determine basic EPS from continuing operations

5

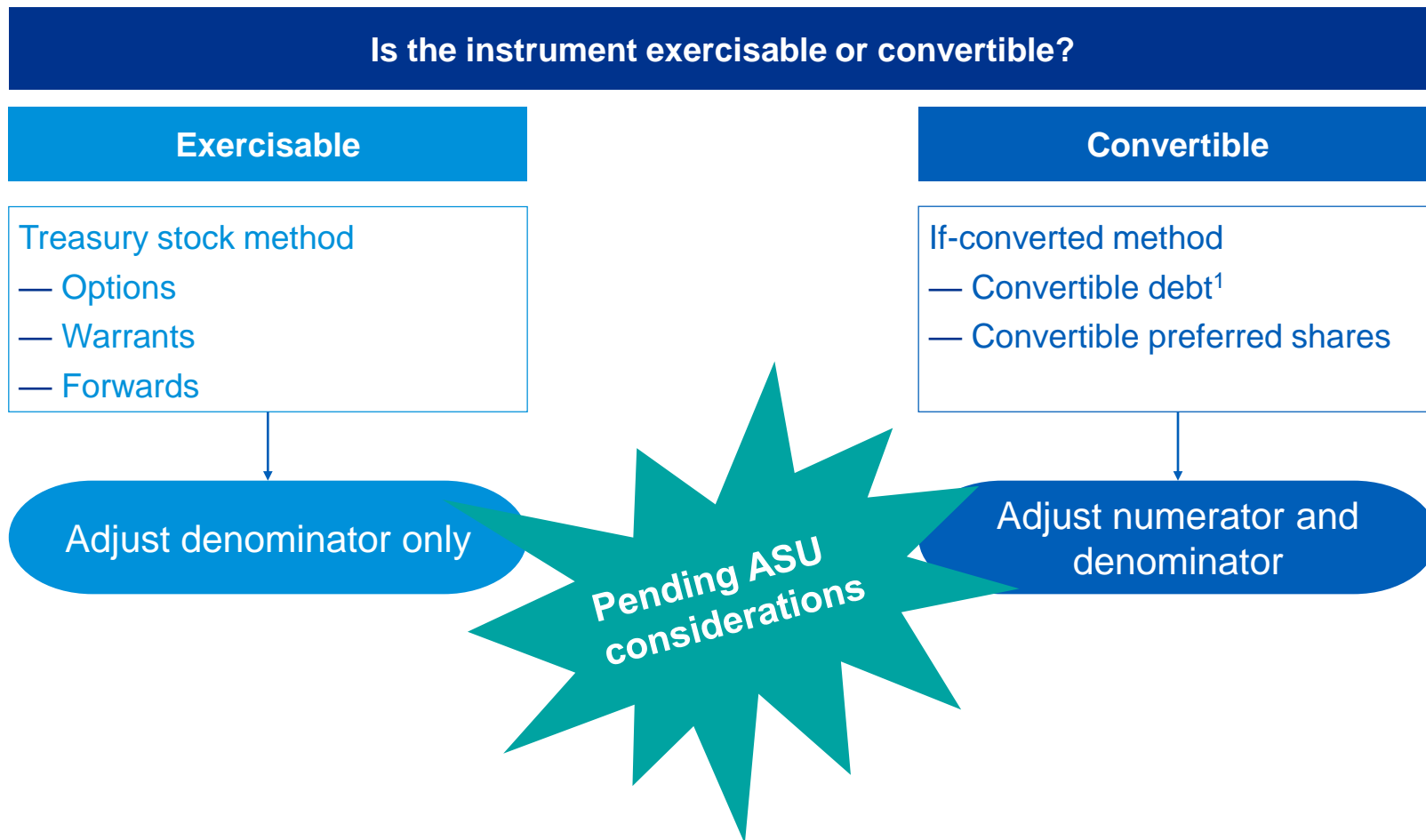
Identify dilutive potential common shares and determine diluted EPS

Determine
control number

Earnings per incremental share (EPIS)



Methods to use



Note:

¹ Except for certain convertible debt instruments that may be settled in cash or shares.

If-converted method

Adjust numerator for:

Dividends, interest and other items deducted in arriving at income available to common shareholders, including:

- Debt issuance costs
- Beneficial conversion features

Other changes in income or loss, such as:

- Profit-sharing arrangements
- Bonuses

Example

Numerator Considerations

On January 1, Year 1, ABC Corp. issues a bond that is convertible into 1,000 common shares.

- Interest expense recognized on the debt in Year 1 is \$1,000.
- ABC has a nondiscretionary employee profit-sharing plan that pays 5% of its income before tax annually to all eligible employees.
- All expenses are tax-deductible. The applicable income tax rate is 21%.

For calculating diluted EPS, ABC assumes:

- Bond is converted into common shares at the beginning of Year 1.
- Interest on the bond would not have been recognized in Year 1, resulting in an increase in income for Year 1, and therefore an increase in the employee profit-sharing plan expense.

Denominator Considerations

ABC Corp. considers the bond converted as of January 1, Year 1, and includes 1,000 common shares in its denominator calculation.

If-converted method

Example (continued)

Numerator adjustment:

	Before tax	Related tax	After tax
Decrease in interest expense	\$1,000	\$(210) [\$1,000 × 21%]	\$790
Increase in employee profit-sharing expense	(50) [\$1,000 × 5%]	11 [\$50 × 21%]	(39)
Numerator adjustment	\$ 950	\$(199)	\$751

Denominator adjustment:

	Number of shares outstanding	Time weighting	Weighted-average number of shares
January 1 to December 31	1,000	12/12	1,000
Weighted average for the year			1,000

Denominator adjustment

Earnings per incremental share (EPIS): $\$751/1,000 = \0.751

Treasury stock method

The treasury stock method

<p><i>Step i</i></p>	<p>Calculate the assumed proceeds</p> <p>Calculate the proceeds that would have been received from the assumed exercise of all options.</p>	<p>'Exercise price'</p> <p>\times</p> <p>Number of options</p>
<p><i>Step ii</i></p>	<p>Calculate the number of common shares deemed to be repurchased at average market price</p> <p>Calculate the number of common shares that would have been repurchased if the proceeds received in Step (i) were used to acquire these shares at their average market price during the period.</p>	<p>Assumed proceeds</p> <p>\div</p> <p>Average market price of shares</p>
<p><i>Step iii</i></p>	<p>Determine the incremental shares</p> <p>Calculate the difference between the number of common shares that would be issued at the exercise of the options and the number of common shares deemed to be repurchased at the average market price.</p>	<p>Number of shares that would be issued</p> <p>$-$</p> <p>Number of shares deemed to be repurchased</p>

Treasury stock method example

ABC Corp. previously issued an equity-classified warrant in a financing transaction.

- Allowed the holder to purchase 10,000 common shares of ABC stock at \$54
- Average market price of ABC's common stock during the reporting period is \$60
- Warrant is outstanding throughout the period.

Therefore, ABC assumes exercise of the warrants and issuance of 10,000 shares of common stock for the treasury stock calculation.

Answer:

- No adjustment to the numerator
- Denominator adjustment:
 - Step 1 – assumed proceeds: \$540,000 ($\$54 \text{ exercise price} \times 10,000 \text{ warrants}$)
 - Step 2 – 9,000 shares of its common stock will be repurchased ($\$540,000 \div \60)
 - Step 3 – 1,000 incremental shares ($10,000 - 9,000$)

Therefore, 1,000 shares are added to the denominator when calculating diluted EPS for the period. EPIS is \$0.

Diluted EPS

Steps 3 – 5

Five-step approach to diluted EPS

1

Identify potential common shares

2

For each potential common share, determine EPIS

3

Rank potential common shares based on EPIS

4

Determine basic EPS from continuing operations

5

Identify dilutive potential common shares and determine diluted EPS

Determine
control number

Example

Rank shares by EPIS

Potential common shares and their EPIS:

	Increase in available income	Increase in number of common shares	EPIS
Options	-	1,000	-
Convertible debt	\$118,500	10,000	\$11.85
Convertible preferred shares	\$4,000,000	2,000,000	\$2.00

The instruments are therefore ranked in this order (lowest to highest EPIS):

1. Options
2. Convertible preferred shares
3. Convertible debt

Dilutive or antidilutive?

Let's run through an example: income available to common shareholders is \$10,000,000 and weighted-average outstanding common shares is 2,000,000 for Basic EPS.

	Income available to common shareholders	Weighted-average common shares	EPS	Dilutive?
As reported (income from continuing operations)	\$10,000,000	2,000,000	\$5.00	n/a
Options	-	1,000		
	\$10,000,000	2,001,000	\$4.99	✓
Convertible preferred shares	\$4,000,000	2,000,000		
	\$14,000,000	4,001,000	\$3.50	✓
Convertible debt	\$118,500	10,000		
	\$14,118,500	4,011,000	\$3.52 ¹	✗

Note:
¹Because diluted EPS increases from \$3.50 to \$3.52 when the convertible debt is included, the convertible debt is antidilutive and is ignored in the calculation of diluted EPS. Therefore, diluted EPS is \$3.50

Polling question #3



Which class of potential common shares generally results in the lowest earnings per incremental share (EPIS)?

- a. Convertible preferred shares
- b. Liability-classified forward contracts
- c. Liability-classified warrants
- d. Options



Polling question #3



Which class of potential common shares generally results in the lowest earnings per incremental share (EPIS)?

- a. Convertible preferred shares
- b. Liability-classified forward contracts
- c. Liability-classified warrants
- d. Options



Contracts that may be settled in shares or cash

Current:

Depends on whether at the option of issuer or holder

— Issuer's option:

- Presume share settlement if more dilutive
- Exception: if past experience or stated policy indicates cash settlement, then may rebut the presumption

— Holder's option:

- Presume share settlement, if dilutive, or alternative that is more favorable to holder

Proposed:

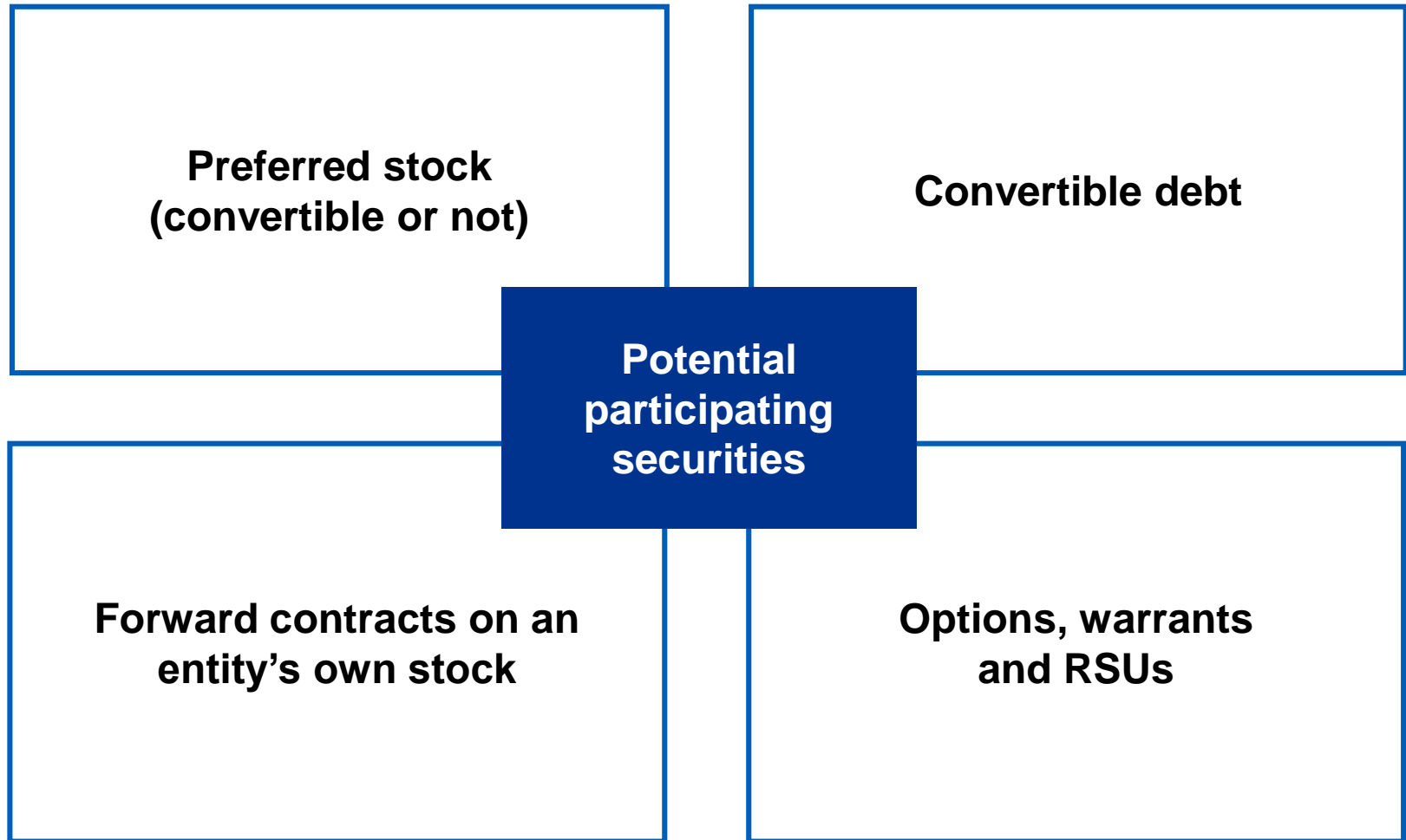
Always assume share settlement if dilutive
(regardless of who holds the option)



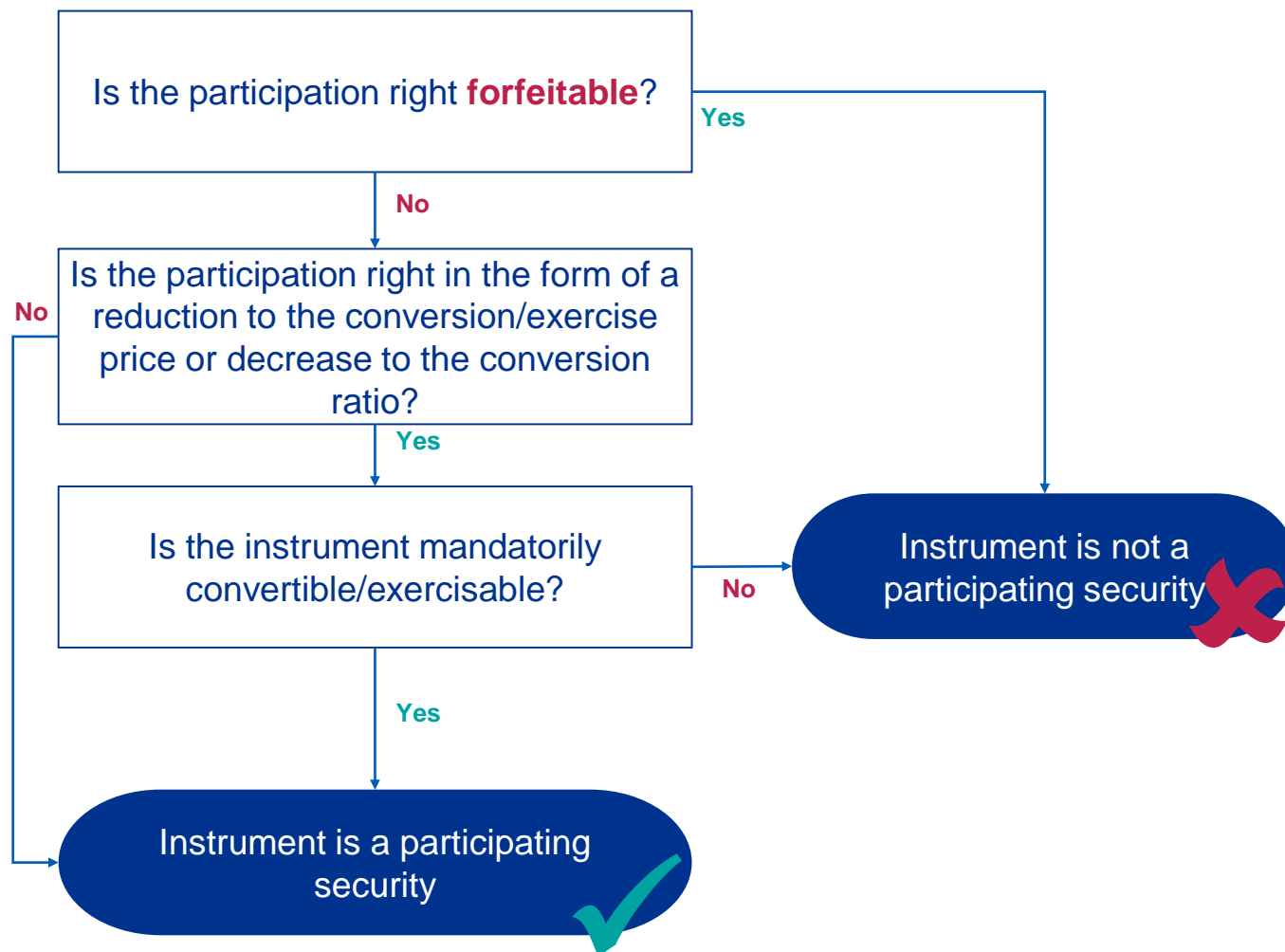


Participating securities and the two-class method

Potential participating securities



Identifying participating securities



Polling question #4

Does your entity have outstanding participating securities?

- Yes
- No
- N/A



The two-class method

Step A

Adjust income (loss) by the amount of dividends declared in the period for each class of security, and by the contractual amount of dividends or interest not recognized in earnings for the period that has yet to be paid – e.g., unpaid cumulative dividends

Step B

Notionally allocate the remaining earnings to the different classes of common stock and participating securities as if all of the earnings for the period had been distributed (participation feature)

Step C

Determine earnings attributable to each class of instruments (numerator) by adding together the amount allocated for dividends (see Step A) and the amount notionally allocated for the participation feature (see Step B)

Step D

Divide earnings attributable to each class of common stock by weighted-average number of shares outstanding for the period

Two class method – income adjustments

Step A: Adjust income (loss) by dividends declared during the period for each class of security and by contractual dividends or interest not recognized in earnings in the period

Adjust for (unless already recognized in earnings):

- Dividends declared in the current period, for each class of security.
- Dividends that were not declared, but must be paid for in the current period – i.e. cumulative preferred dividends.

But do not adjust for:

- Prior-year cumulative dividends that were not paid at the time, but declared during the current period.
- Unearned preferred dividends that are cumulative only if earned.
- Dividends on share-based payment awards that are not expected to vest and have been charged to expense.

Two-class method Step A example

ABC Corp. has two classes of equity instruments, X and Y, with the following rights:

- Holders of Class X are entitled to a fixed dividend per share and have the right to participate in any additional dividends declared. Dividends are discretionary.
- Holders of Class Y participate equally with holders of Class X with respect to any additional discretionary dividends only.
- Both classes of shares participate equally in residual assets upon liquidation.

The following information is also relevant:

- ABC's net income for the period: \$2,500
- Dividends paid to holders of Class X: \$ 600
- Dividends paid to holders of Class Y: \$ 500
- Number of shares outstanding for the period: 100 for both Class X and Class Y.

ABC concludes that the Class Y shares are the only *common* shares for which EPS disclosure is required.

Net income		\$2,500
Less:	Dividends paid:	
	To holders of Class X	(600)
	To holders of Class Y	<u>(500)</u>
	Total	<u>(1,100)</u>
Remaining earnings		<u>\$1,400</u>

Two-class method Step B example

Step B: Notionally allocate remaining earnings to the different classes of securities

Remaining earnings after Step A adjustments is \$1,400.

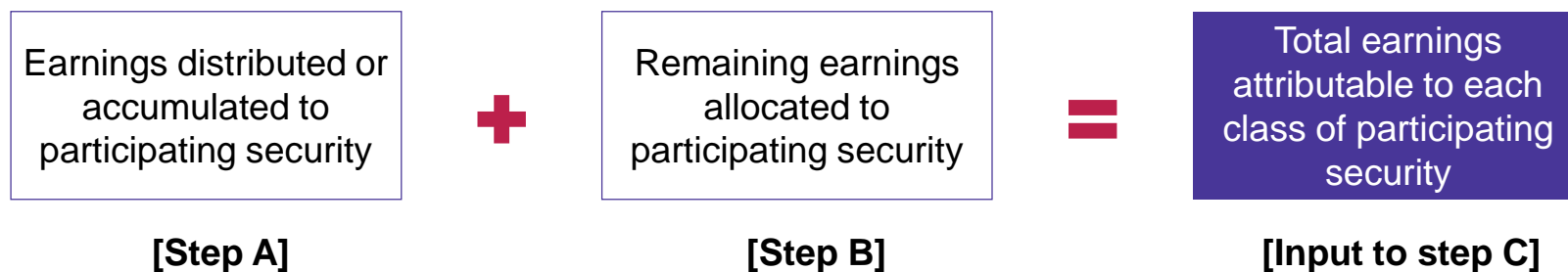
	Class X shares (participating equity instruments)	Class Y shares (common shares)
Shares outstanding	100	100
Remaining earnings allocated to each class of security	\$700 [$\$1,400 \times 100 \div 200$]	\$700 [$\$1,400 \times 100 \div 200$]

Participation rights must
be objective and
nondiscretionary

Additional
considerations:
– Allocating losses
– Contingencies

Two-class method Step C example

Step C: Determine total earnings allocated to each class of security



	Class Y
Dividends paid (from Step A)	\$ 500
Remaining earnings (from Step B)	700
Total earnings attributable to security	\$1,200

Two-class method Step D example

Step D: Divide total earnings allocated to common shares by weighted-average number of shares outstanding for the period

	Class Y
Total earnings attributable to security	\$ 1,200
Weighted-average number of shares outstanding	<u>100</u>
Basic EPS	<u><u>\$ 12.00</u></u>



Retrospective adjustments

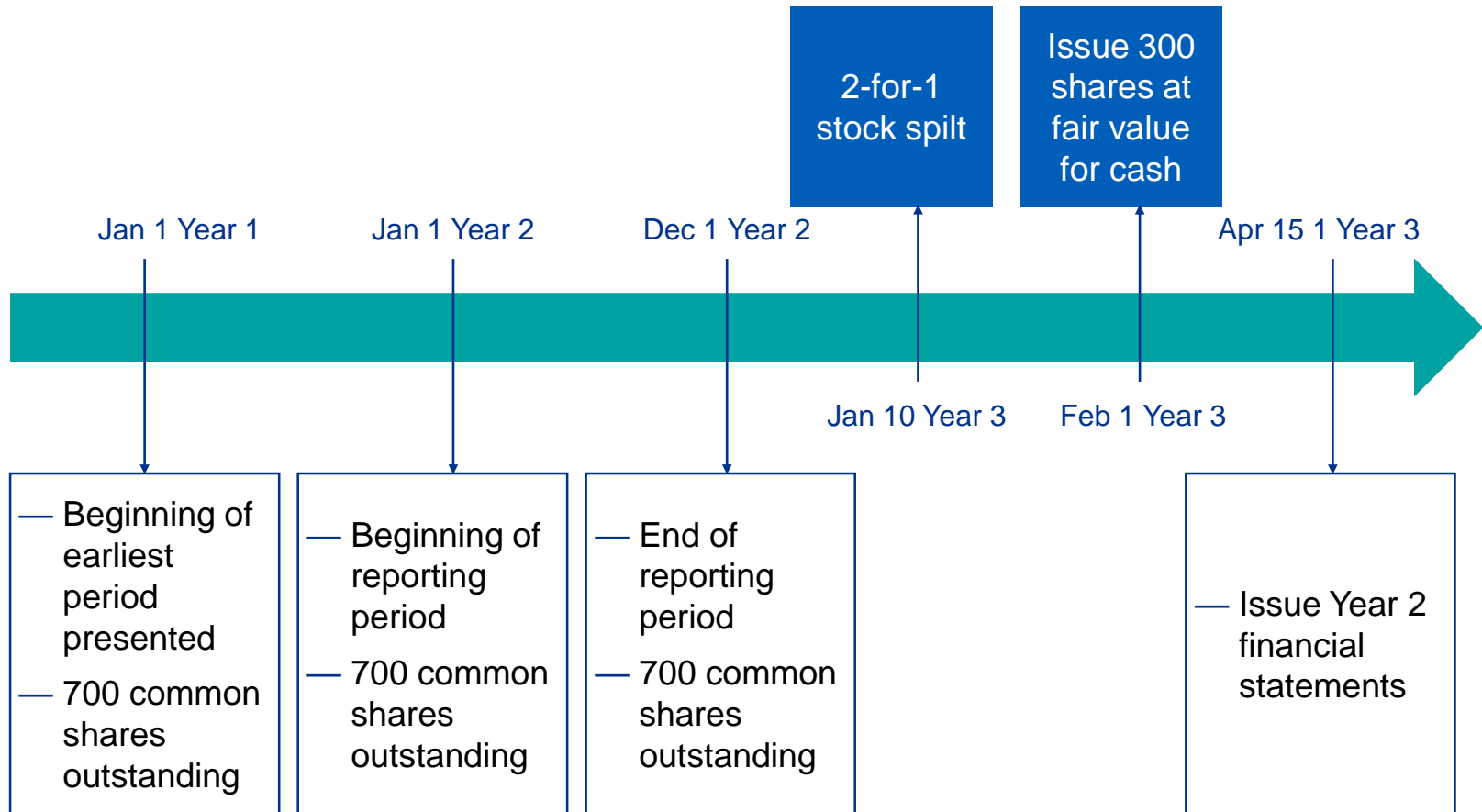
Retrospective adjustments

Stock dividend, stock split, reverse stock split	Retrospectively adjust denominator to reflect the weighted-average number of shares outstanding after the event.
Rights issue	Retrospectively adjust denominator for the bonus element based on prescribed formula.
Reverse acquisition and reorganizations	Retrospectively adjust numerator and denominator based on prescribed formula.
Accounting changes retrospectively applied and error corrections	Retrospectively adjust ¹ numerator to reflect accounting change or correction (adjust denominator if necessary).

Note:

1. Restatement of financial statements to correct an error may result in a restatement of EPS.

Stock split





EPS in interim financial statements

Quarterly EPS

- Each quarterly calculation is determined independently.
- Year-to-date calculation of diluted EPS is based on the weighted-average of incremental shares included in each interim period in the year-to-date calculation, with some exceptions.
- Contingent shares are included on a weighted-average basis for year-to-date calculations.
 - For interim periods they are included as of the beginning of that period.



Example

ABC's income information is detailed below.

ABC has 100,000 shares of common stock and 20,000 options outstanding for the entire year.

	Q1	Q2	Q3	Q4	Full year
Income from continuing operations	\$(5,000)	\$(5,000)	\$110,000	\$200,000	\$300,000
Common shares (from basic calculation)	100,000	100,000	100,000	100,000	100,000
Incremental shares (for diluted calculation)	0 ¹	0 ¹	20,000	20,000	20,000
Basic EPS	\$(0.05)	\$(0.05)	\$1.10	\$2.00	\$3.00
Diluted EPS	\$(0.05)	\$(0.05)	\$0.92	\$1.67	\$2.50

Note:

¹ No shares are included due to loss in the period.

The sum of the quarterly diluted EPS amounts $[(\$0.05)+\$0.05)+\$0.92+\$1.67] = \mathbf{\$2.49}$, however diluted EPS for the full year is **\$2.50**.



Presentation and disclosure

Presentation requirements

- **EPS presented on face of income statement**
 - Presented for income from continuing operations and net income, with equal prominence.

- **EPS presented and information disclosed for every period for which an income statement is presented**

- **EPS from discontinued operations may be presented in the notes**

- **Required disclosures in the notes to the financial statements:**
 - Numerator used for calculating basic and diluted EPS
 - Denominator used for calculating basic and diluted EPS
 - Reconciliation of numerator to net income, if materially different
 - Reconciliation of denominators used in basic and diluted EPS
 - Potential common shares not included in diluted EPS because they were antidilutive, and their terms and conditions
 - Recognized subsequent events that affected EPS (retrospective adjustment)
 - Material unrecognized subsequent events that would have significantly affected EPS

Other per share amounts?

	In Income Statement?	In notes to Financial Statements?
EPS from discontinued operations [260-10-45-3]	R ¹	R ¹
Cash flow per share [260-10-45-6]	X	X
EPS effect of restructurings [260-10-45-5]	X	V
EPS for participating securities other than common stock [260-10-45-60]	V	V
EPS effect of items that are unusual or infrequently occurring [260-10-45-5]	X	V
Other per-share amounts [260-10-45-5]	X	V

R = required, V = voluntary, X = prohibited

Note:

¹ Presentation is required, either on the face of the income statement or in the notes to the financial statements.

Polling question #5



Which of the following is prohibited to be presented, whether on the face of the financial statements or in the notes?

- a. EPS from discontinued operations
- b. EPS for preferred shares
- c. Cash flows per share
- d. Effect of restructuring per share



Polling question #5



Which of the following is prohibited to be presented, whether on the face of the financial statements or in the notes?

- a. EPS from discontinued operations
- b. EPS for preferred shares
- c. Cash flows per share**
- d. Effect of restructuring per share





Q&A

Thank you

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