

FINANCIAL REPORTING

IAS 33: Earnings per share

OBJECTIVE OF THE STANDARD

To prescribe principles for the determination and presentation of earnings per share, to improve **performance comparisons** between different entities in the same reporting period and between different reporting periods for the same entity.

The standard is able to achieve comparability by;

- Defining earnings.
- Prescribing methods for determining the number of shares to be included in the calculation of EPS.
- Demanding standard presentation and disclosures.

SCOPE OF THE STANDARD

The standard applies to the **separate or individual financial statements** of an entity; **and to the consolidated financial statements of a group with a parent;**

- whose ordinary shares or potential ordinary shares are traded in a public market.
- that has filed, or is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing ordinary shares in a public market.

Entities which present both separate and consolidated financial statements are only required to present EPS based on the consolidated information.

TYPES AND MEASUREMENT OF EARNINGS PER SHARE

Earnings per share (EPS)

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graph TD; A[Earnings per share (EPS)] --> B[Basic EPS]; A --> C[Diluted EPS]
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Basic EPS

Diluted EPS

Measurement of basic earnings per share

Objective: to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity by the weighted average number of ordinary shares outstanding during the period.

Therefore;

$$\text{Basic EPS} = \frac{\text{Earnings}}{\text{Shares}}$$

Earnings: Profit after tax less after-tax preference dividends. In case of EPS for consolidated financial statements, profit or loss attributable to the parent is the profit or loss of the consolidated entity less non-controlling interest.

Shares: weighted average number of ordinary shares in issue (outstanding) during the period.

Shares outstanding are multiplied by the time weighting factor which is the number of days the shares are outstanding as a proportion of the total number of days in the period.

MEASUREMENT OF BASIC EPS CONT'D

The denominator in the formula can change during the period for any issue of additional share.

Categories of issue of shares may include;

- ***Issue of shares at their full market price***

The number of shares issued for purposes of computing basic EPS are computed whilst taking account of the date any new shares are issued during the year.

- ***Bonus issue/capitalization issue/script issue***

Here, ordinary shares are issued to existing shareholders for no additional consideration. Therefore, the number of ordinary shares outstanding is increased without an increase in resources. Additionally, the shareholder owns the same proportion of the business before and after the issue.

Whilst computing EPS;

- ❖ bonus shares are deemed to have been issued at the start of the year regardless of the actual date when the bonus issue took place.
- ❖ comparative figures are restated to allow for the proportional increase in share capital caused by the bonus issue. Doing this treats the bonus issue as if it had always been in existence hence allowing comparability between the current and previous period.

MEASUREMENT OF BASIC EPS CONT'D

▪ *Rights issue*

This is an issue of ordinary shares to existing shareholders at a price less than the fair value of the shares. Therefore, they combine the characteristics of issues at full market price and bonus issues.

Steps followed in calculating EPS with a rights issue

- ❑ Calculate the theoretical ex-rights price (TERP)

Start with the number of shares previously held by an individual at their market price. Then add in the number of new shares purchased at the rights price. You can then find the TERP by dividing the total value of these shares by the total number of shares held.

- ❑ Compute the bonus fraction

$$\text{Bonus fraction} = \frac{\text{Market price before issue}}{\text{Theoretical ex-rights price (price after)}}$$

- ❑ Compute the weighted average number of shares
- ❑ Compute the EPS

ILLUSTRATIONS

Illustration one

Mangu Ltd had 500,000 ordinary shares (of Shs 1,000 each) in issue on 30 June 2022. During the year ended 30 June 2023, the company issued an additional 300,000 shares at full market price of Shs 2,500 each on 31 December 2022. The company's profit for the year ended 30 June 2022 and 2023 was Shs 250 million and Shs 320 million respectively.

Required:

Compute Mangu's Earnings per share for the years ended 30 June 2022 and 30 June 2023.

Illustration two

Mangu Ltd had 500,000 ordinary shares (of Shs 1,000 each) in issue on 30 June 2022. During the year ended 30 June 2023, the company made a bonus issue of one share for every four existing shares on 31 December 2022. The company's profit for the year ended 30 June 2022 and 2023 was Shs 250 million and Shs 320 million respectively.

Required:

Compute Mangu's Earnings per share for the years ended 30 June 2022 and 30 June 2023.

ILLUSTRATIONS

Illustration three

Mundu company limited had 10 million shares in issue on 1 January 2022. They issued 2,000,000 shares at market value on 31 March 2022, followed by a 1 for 5 bonus issue on 1 September 2022, with a further 3,000,000 issued at market value on 1 November 2022. Mundu's profit for the year ended 31 December 2022 was Shs. 2.3 million.

Required:

Compute Mundu's Earnings per share for the year ended 31 December 2022.

Illustration four

On 31 December 2021, A company issued share capital consisted of 4,000,000 ordinary shares of Shs. 100each. On 1 July 2021 the entity made a rights issue in the proportion of 1 for 4 at Shs. 200 per share and the shares were quoted immediately before the issue at Shs. 300 Each. The following information was provided relating to the company:

Year ended 31 December	2021	2020
	Shs	Shs
Profit after tax	42,500,000	32,000,000

Required:

Compute the value of earnings per share to be included in the financial statements of the company for the year ended 31 December 2021.

MEASUREMENT OF DILUTED EARNINGS PER SHARE

Objective: To provide a measure of the interest of each ordinary share in the performance of an entity, while giving effect to all dilutive potential ordinary shares outstanding during the period.

This is based on the fact that equity share capital may increase in the future due to circumstances which exist now, and such increases will reduce or dilute the earnings per share. Hence diluted EPS works as an alert to the existing shareholders of the potential impact of additional shares on EPS.

Diluted earnings per share adjusts profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

Measurement

$$\text{Diluted EPS} = \frac{\text{Earnings} + \text{notional extra earning}}{\text{Number of shares} + \text{notional extra shares}}$$

Earnings: The profit or loss attributable to ordinary equity holders of the parent entity is adjusted for the after-tax of;

- any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity.
- any interest recognized in the period related to dilutive potential ordinary shares.
- any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

MEASUREMENT OF DILUTED EARNINGS PER SHARE CONT'D

Shares: The weighted average number of ordinary shares as per basic EPS is adjusted for (by adding) the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

Dilutive potential ordinary shares are assumed to have been converted to equity shares on the first day of the accounting period, or on the date they are issued, if later.

Diluting factors may include;

Convertible instruments

Convertible instruments are financial instruments which give the holder the right to either demand repayment of the principal amount or alternatively convert the balance into shares.

If convertible bonds/preference shares had been converted;

- the interest/dividend would be saved therefore earnings would be higher
- the additional earnings would be subject to tax
- the number of shares would increase

ILLUSTRATION ON CONVERTIBLES

Asawo company limited (ACL) had 8.28 million shares in issue on 1 January 2023. No new shares were issued by ACL during the year ended 31 December 2023, but on that date, it had in issue Shs. 2,300,000 convertible loan stock with an effective interest rate of 10%. ACL pays income tax at the rate of 30% and the earnings for the year were Shs 2,208,000.

The loan stock can be converted into 90 ordinary shares of Shs 1 each for every Shs 100 nominal value of loan stock.

Required: Calculate the diluted earnings per share for the year ended 31 December 2023.

MEASUREMENT OF DILUTED EARNINGS PER SHARE CONT'D

Options and warrants to subscribe for shares

An option or warrant gives the holder the right to buy shares at some time in the future at a predetermined price.

The total number of shares issued on the exercise of the option or warrant is split into two;

- the number of shares that would have been issued if the cash received had been used to buy shares at fair value (using the average price of the shares during the period).
- the remainder, which are treated like a bonus issue (i.e. as having been issued for no consideration).

Number of free shares = Number of options x $\frac{\text{Fair value less exercise price}}{\text{Fair value}}$

Importance of a diluted earnings per share

- it shows what the current year's EPS would be if all the dilutive potential ordinary shares in issue had been converted.
- in theory, it serves as a warning to equity shareholders that the return on their investment may fall in future periods
- it can be used to assess trends in past performance

ILLUSTRATION

Axle and Company (AC) is a company whose shares are publicly traded on the Ugandan stock exchange market. Given the nature of its trade, AC has various actual and potential stakeholders who require information regarding its performance to make their decisions. Management is working tirelessly to ensure that they provide such information and has been advised by its consultants to apply the fundamental qualitative characteristics of useful financial information, if the company's information is to be useful to its stakeholders.

On 1 January 2021, AC had in issue Shs 50 million 10% convertible debenture. This debenture is convertible into ordinary shares at a rate of 500 ordinary shares for every one million debenture stock. The company also had outstanding 10,000 share options which are to be exercised five years later at a price Shs 9,000 per share. The average market price per share of AC shares during the year ended 31 December 2021 was Shs 11,000. AC had 100,000 ordinary shares during the year and made a net profit Shs 820 million for the year ended 31 December 2021. Out of the net profit for the year, Shs 57 million is attributed to the non-controlling interest. The corporate tax rate is 30%.

Required: Compute the basic and diluted EPS for the year ended 31 December 2021

BENEFITS AND LIMITATIONS OF EPS

Importance of EPS

- Its an important factor in studying performance trends than mere basing on profit.
- Helps in computation of price earning ratio (P/E ratio), a major stock market indicator of performance.

$$\text{P/E ratio} = \frac{\text{Market value of a share}}{\text{EPS}}$$

Limitations of EPS

- An entity's earnings are affected by the choice of its accounting policies.
- EPS is an historical figure based on historical accounts, and therefore it does not necessarily have predictive value.
- It assumes earnings is the only measure of performance of an entity.
- EPS cannot be used as a basis of comparison between companies, as the number of shares in issue in any particular company is not related to the amount of capital employed.
- EPS is dependent on an earnings figure which is subject to many areas of judgement.

CONDITIONS FOR RESTATEMENT OF EPS

- If the number of ordinary or potential ordinary shares outstanding increases as a result of a capitalization, bonus issue or share split, or decreases as a result of a reverse share split.
- Basic and diluted EPS must be adjusted for effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively.

PRESENTATION

- An entity must present basic and diluted earnings per share in the statement of comprehensive income for profit or loss from continuing operations attributable to the ordinary equity holders.
- An entity that reports a discontinued operation must disclose the basic and diluted amounts per share for the discontinued operation either in the statement of comprehensive income or in the notes.
- An entity must present basic and diluted earnings per share, even if the amounts are negative (i.e., a loss per share).

DISCLOSURES

- The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period.
- The weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other.
- Instruments that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share.
- A description of ordinary share transactions or potential ordinary share transactions.