

Calculating diluted earnings per share

What is the issue?

An entity's diluted earnings per share information expands on the basic earnings per share (EPS) numbers by including information on, for example, options that are convertible to shares.

In this article we consider one aspect of the accounting for diluted EPS that can be challenging in practice. It relates to how options granted as share-based payment awards are included in the calculation of an entity's diluted EPS.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Who does it impact?

All entities that disclose earnings per share information.

What is diluted EPS and why is it important to shareholders?

Diluted EPS takes account of any dilutive potential ordinary shares. Potential ordinary shares are contracts such as options that may entitle the holder to ordinary shares in the future once certain conditions in a contract have been met. Potential ordinary shares are considered dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares on issue during the period.

Information on an entity's diluted EPS is important to shareholders, investors and analysts because it enables them to measure the entity's performance throughout the reporting period, while considering the effect of dilutive potential ordinary shares that were outstanding in the period. Diluted EPS also gives an indication of future distributable profits.

An entity has 1000 options outstanding with an exercise price of \$1.50. The average market price per share for the period was \$4. The assumed proceeds of \$1500 (1000 x \$1.50) could buy 375 shares at the current market price. A total of 625 shares would be considered dilutive and would be added to the number of shares used when calculating the entity's diluted EPS.

Including share-based payment options in the diluted EPS calculation

Issue in practice: It's common for entities to issue share options and other share-based payment awards to incentivise employees. Under these awards, share options or rights are granted on the basis that the employee continues to give service for a specified period. Some awards may also require the employee to achieve a certain performance condition (for example, meet an earnings target or grow the entity's share price). Even though these awards are contingent upon vesting in the future, employee share options with fixed or determinable terms and non-vested ordinary shares may need to be treated as 'potential ordinary shares' in the entity's diluted EPS calculation.

PwC insight: Entities should examine their awards to determine whether they give rise to potential ordinary shares. For example, options that vest subject only to a service condition are automatically regarded as being outstanding from the grant date, and they should be considered in the diluted EPS calculation. In contrast, where the vesting of the options is conditional on meeting a performance condition, the general 'rule of thumb' is to include the potential ordinary shares in the diluted EPS calculation based on the number of shares that would be issuable if the end of the reporting period was also the end of the contingency period. In other words, if the condition was being met at the end of the reporting period, the options would need to be considered for diluted EPS. For example:

- Where the performance condition is based on achieving a certain earnings level, and that level must be maintained for the whole vesting period, the options would be considered for the diluted EPS calculation when the earnings level has been achieved at balance sheet date (even though it will need to be maintained for the remaining vesting period).
- Where the number of shares issuable in the future depends on the market price of the entity's share at a future date, the entity's diluted EPS should reflect the share price at the end of the reporting period. Many awards require an average share price to be maintained beyond the end of the reporting period. Entities with these awards need to determine whether the average share price for the period (based on the average for the period that has elapsed) meets the employee's performance target.
- If, in a subsequent period, there is a decline in earnings/share price which means the target won't be met, the options shouldn't be included in the dilutive EPS in that period. Moreover, the previous period's EPS should not be restated.

How do I reflect share-based payment options in diluted EPS?

Issue in practice: Some entities are unsure how to determine if an option granted via a share-based payment is dilutive.

PwC insight: To determine whether an award is dilutive, entities should consider the benefit they will receive from the option. For a share-based payment arrangement this would comprise two elements: i) the option's exercise price; and ii) the benefit of any future service from the employee. The second element would be reflected in the share-based payment expense that is yet to be recognised over the remainder of the vesting period.

Using the above example as a guide, assume the options vest over a three-year period and have a grant date fair value of \$3. The assumed proceeds at the end of year one are deemed to be \$3.50 per option (\$1.50 exercise price + \$2 unexpensed value). The assumed proceeds of \$1350 (1000 x \$3.50) could buy 875 shares. In this case 125 shares would be considered fully dilutive.

Entities should also be aware that an award will become increasingly dilutive as it approaches its vesting date. The longer the options have been outstanding, the more of the grant date fair value will have been expensed, which increases the likelihood of the options becoming dilutive (provided the share price doesn't decrease).

More focus on fair value under the new IFRS 7

What is the issue?

In response to the global financial crisis, earlier this year the IASB amended IFRS 7 *Financial Instruments: Disclosure* to require entities to disclose more information about their financial instruments.

The amendments give users of financial statements more information about the risks associated with the valuations and methodologies entities use.

The amendments apply to periods beginning from 1 January 2009 (they are mandatory for annual Dec 2009 accounts).

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Who does it affect?

All entities that measure one or more of their financial instruments at fair value. Financial instruments that are commonly measured at fair value include investments in listed securities, private equity, government securities, government bonds, all derivatives (such as interest rate swaps) and complex financial liabilities.

What are the key changes to IFRS 7 and how do they change current practice?

All financial instruments measured at fair value in the balance sheet must be classified into a new three-level fair value hierarchy (refer to box below). The levels in the fair value hierarchy drive the disclosures that entities need to make about these types of financial instruments. The hierarchy is designed to help users of financial statements understand how the entity's fair value measurement was determined and the reliability of any estimates or assumptions used. The hierarchy identifies which assumptions, estimates and other inputs are observable in the market (and are therefore more objective), versus those that are not observable in the market (and are therefore more subjective).

Introducing the new fair value hierarchy

Level 1. Quoted prices in active markets for identical assets and liabilities. The inputs (that is, the assumptions and other estimates) used to measure the financial instrument are readily available in the market and are typically obtainable from multiple sources. For example, equities listed on the stock exchange, government bonds that are actively traded, and listed corporate bonds.

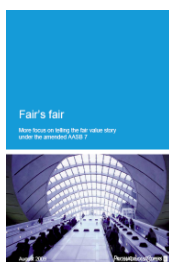
Level 2. Fair values based on observable market data. All significant inputs used to measure the financial instrument are observable in the market either directly (ie, as prices) or indirectly (ie, derived from prices). These inputs must be observable for substantially the full term of the financial instrument. For example, unlisted corporate bonds where a market credit rating is available and government bonds that are not actively traded.

Level 3. Fair values based on market data that are not observable in the market. The inputs used to measure the financial instrument are not based on observable market data. For example, some long-dated interest rate options, long-dated foreign currency derivatives, and unlisted equity investments where the valuation is determined using management's financial forecasts.

In addition to disclosing the level of the financial instrument in the fair value hierarchy, entities must disclose the following information for each class of financial instruments:

- i. Any significant transfers between Level 1 and Level 2 of the hierarchy and the reasons for those transfers;
- ii. Their accounting policy for recognising the difference (if any) at transaction date between the transaction price and the fair value of the financial instrument using a valuation technique ("day one profit or loss"); and
- iii. Where fair value measurements are within the Level 3 category of the hierarchy:
 - a reconciliation from the beginning balances to the end balances
 - if the fair value would change significantly by using alternative reasonably possible assumptions, entities must disclose that fact, the effect of those changes, and how the effect was calculated.
 - key assumptions and estimates (eg, relating to pre-payment rates, interest rates, or discount rates).

The amendments to IFRS 7 also enhance the disclosures required about entities' liquidity risk, primarily in relation to any derivative instruments, financial guarantees, and financial assets the entity holds.



PwC insight: An opportunity in disguise for management (plus new guidance from PwC)

The amendments give management the opportunity to evaluate and refine their fair value measures and techniques. We expect the new disclosure requirements to be a key area of focus for those charged with governance, such as the audit committee and the board, so it's imperative that management has a clear understanding of the impacts of their fair value measures and assumptions on their business. To help you apply the amendments to your business, request a copy of the new guidance titled *Fair's fair - More focus on telling the fair value story under the amended IFRS 7* by emailing ifrs.communications@au.pwc.com.