Chapter 19
Share-Based Compensation and Earnings Per Share
Part 2: Simple EPS

Student Learning Outcomes
• Incorporate preferred dividends into the EPS calculation
• Compute the weighted average number of shares of common stock
• Calculate simple earnings per share (basic earnings per share)
• Part 3: Diluted earnings per share – exercisable securities
• Part 4: Diluted earnings per share – convertible securities

Simple (Basic) EPS Calculation
• Earnings per share = EPS
• Net Income ÷ # Shares of Common Stock Outstanding
Net Income

• Net Income is the income available to common shareholders
• What about preferred shareholders?
• Subtract Preferred Dividends
  • If the preferred stock is cumulative, whether or not declared
  • If the preferred stock is noncumulative, only if declared

# Shares Common Stock Outstanding

• Determined on weighted average basis
• Apply stock dividends, stock splits and reverse splits retroactively
• Includes Common Stock Equivalents (CSE) that are dilutive

Weighted Average Basis

• Applies a weight, based on the number of months that the stock has been outstanding
• For Example: On 1/1, Apex Corp. had 8,000 shares of common stock outstanding. On 4/1, it issued an additional 1,000 shares. On 8/1, it reacquired and retired 3,000 shares.
  1/1 – 12/31 \[ 8,000 \times (12 \div 12) = 8,000 \]
  4/1 – 12/31 \[ 1,000 \times (9 \div 12) = 750 \]
  8/1 – 12/31 \[ (3,000) \times (5 \div 12) = 1,250 \]
  Weighted Average # Shares = \[ 7,500 \]
Retroactive Application

- Applies to stock dividends, stock splits and reverse splits
- Treated as though it occurred at the beginning of the period

For Example

On 1/1, Apex Corp. had 8,000 shares of common stock outstanding. On 4/1, it issued an additional 1,000 shares. On 6/1, Apex declared and distributed a 10% stock dividend. On 8/1, it reacquired and retired 3,000 shares.

\[
\begin{align*}
1/1 - 12/31 & : 8,000 \times \left( \frac{12}{12} \right) = 8,000 \\
4/1 - 12/31 & : 1,000 \times \left( \frac{9}{12} \right) = 750 \\
8/1 - 12/3 & : (3,000) \times \left( \frac{5}{12} \right) = (1,250) \\
\text{Weighted Average # Shares} & = 8,375
\end{align*}
\]

Common Stock Equivalents

- Securities that can be turned into common stock
  - Convertible
    - Debt – Bonds
    - Equity – Preferred Stock
  - Exercisable
    - Stock options
    - Stock warrants
    - Stock rights
- More on this later
Example

On 1/1, Apex, Inc. had 820,000 shares of common stock outstanding, and 2,000 shares of 8% $100 par cumulative preferred stock. No dividends were declared on either the preferred or the common stock. Net income for the year was $426,000. The income tax rate is 40%. There were no stock transactions during the year. What is the Earnings Per Share?

Example (continued)

• (Net Income – Preferred Dividends) ÷ Weighted Average # Shares Common Stock Outstanding.
• Net Income = $426,000
• Preferred Dividends = (8% x $100) x 2,000 = $16,000
• Weighted Average # Shares = 820,000
• EPS = ($426,000 - $16,000) ÷ 820,000 = $0.50

Another Example

Apex, Inc., reported net income of $743,990. The company had 741,000 shares of common stock outstanding on January 1. It sold 36,000 shares on March 1. As part of an annual share repurchase plan, 6,000 shares were retired on May 1 for $47 per share. What is Apex’s earnings per share?
Another Example (continued)

- Net Income = $743,990
- Preferred Dividends = $0
- Weighted Average # Shares Outstanding
  1/1 – 12/31: 741,000 x (12 ÷ 12) = 741,000
  3/1 – 12/31: 36,000 x (10 ÷ 12) = 30,000
  5/1 – 12/31: (6,000) x (8 ÷ 12) = (4,000)
- Weighted Average # Shares: 767,000
- EPS = $743,990 ÷ 767,000 = $0.97

The Next Step

- Part 3 – Diluted earnings per share – exercisable securities
- Part 4 – Diluted earnings per share – convertible securities