Chapter 19
Share-Based Compensation and Earnings Per Share
Part 3: Diluted EPS – Exercisable Securities

Student Learning Outcomes

• Apply the test for dilution for exercisable securities
• Apply the Treasury Stock method in the computation of diluted earnings per share.
• Part 4: Diluted Earnings Per Share: Convertible Securities

Complex Capital Structure

• Common Stock Equivalents that are dilutive
  ▪ Exercisable
  ▪ Convertible
• Two Earning Per Share figures
  ▪ Basic Earnings Per Share
  ▪ Diluted Earnings Per Share
• Diluted Earnings Per Share – the maximum potential dilution or decline in EPS
Exercisable Securities: Test for Dilution

- Stock Options, Stock Rights, Stock Warrants
- Provide the holder the right to acquire common stock at a set price (exercise price) over a specific period of time
- Would EPS decline if the securities were exercised?
- Test for dilution compares exercise price with average market price of common stock
- Dilutive: If exercise price < average market price
- Anti-dilutive: If exercise price ≥ average market price. Ignore in all computations.

Concept of Dilution

- Would it cause the earnings per share figure to be smaller?
- Exercisable securities – additional shares of stock would be issued
- Only impacts the denominator in the computation

For Example

- Apex, Inc., issued 10,000 stock options to its key executives. Each stock option allows the holder to acquire one share of common stock for $20 per share (exercise price).
- Assume the average market price is
  - $25: Dilutive because the exercise price of $20 is < the average market price of $25
  - $15: Anti-dilutive because the exercise price of $20 is ≥ the average market price of $15
  - $20: Anti-dilutive because the exercise price of $20 is ≥ the average market price of $20
Treasury Stock Method

- Used in the computation of diluted EPS with respect to exercisable securities that are dilutive
- Impacts only the denominator
- Exercise is assumed to have taken place at the later of the beginning of the period or the date of issue of the security

Treasury Stock Method (continued)

- Assumes that the proceeds received upon assumed exercise are immediately used to buy back the company's common stock on the open market at the average market price.
- Weighted average # of shares of common stock outstanding (denominator) is adjusted by adding to it the weighted average net increase in the number of shares outstanding (# shares assumed on exercise - # shares assumed repurchased).
- Incorporated into diluted EPS before any consideration of convertible securities.

For Example

- Apex, Inc., reported net income of $250,000 for the year ended December 31, 2013. On January 1, 2013, it had 100,000 shares of common stock outstanding. No changes to the shares outstanding occurred during 2013. On July 1, 2012, Apex issued 10,000 stock options to its key executives. Each option permits the holder to acquire one share of common stock for $10 per share (exercise price). The average market price of the common stock was $25. Compute basic and diluted earnings per share for 2013.
For Example (continued)

- Net Income = $250,000
- Weighted average # shares = 100,000
- Basic EPS = $250,000 ÷ 100,000 = $2.50
- Test for dilution of options
  - Is exercise price ($10) < average market price ($25)? Yes

For Example (continued)

- Treasury Stock Method
  - Assume exercise at later of 6/1/12 or 1/1/13.
  - # shares issued on exercise = 10,000
  - Proceeds received on assumed exercise = $100,000 ($10 x 10,000)
  - # shares assumed repurchased at average market price = 4,000 ($100,000 ÷ $25)
  - Net increase in # shares = 6,000 (10,000 – 4,000)
- Diluted EPS = $250,000 ÷ (100,000 + 6,000) = $2.36

The Next Step

- Part 4: Diluted Earnings Per Share: Convertible Securities