

The logo of Galgotias University is a stylized 'G' composed of three curved, overlapping bands in shades of yellow, blue, and red, set against a light grey circular background.

# **Earnings per Share (EPS)**

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## Lecture - 2

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## Topic covered

Diluted EPS : Concept

Diluted EPS : Calculation

Diluted EPS Factors : Convertible Instruments

Diluted EPS Factors : Options and Warrants

Diluted EPS : Importance

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## Diluted EPS : Concept

Equity share capital may increase in the future due to circumstances which exist now. When it occurs, this increase in shares will reduce, or dilute, the earnings per share. The provision of a diluted EPS figure attempts to alert shareholders to the potential impact on EPS of these additional shares.

*Examples of dilutive factors are:*

- the conversion terms for convertible bonds/convertible loans etc.
- the exercise price for options and the subscription price for warrants.

## Diluted EPS : Calculation

### Basic principles of calculation

To deal with potential ordinary shares, adjust the basic earnings and number of shares assuming convertibles, options, etc. had converted to equity shares on the first day of the accounting period, or on the date of issue, if later.

DEPS is calculated as follows:

$$\frac{\text{Earnings} + \text{notional extra earnings}}{\text{Number of shares} + \text{notional extra shares}}$$

## Diluted EPS Factors : Convertible Instruments

The principles of convertible bonds and convertible preference shares are similar and will be dealt with together.

If the 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.

## **Diluted EPS Factors : Options and Warrants**

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

Cash is received by the entity at the time the option is exercised, and the DEPS calculation must allow for this.

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## Diluted EPS Factors : Options and Warrants

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).

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## Diluted EPS Factors : Options and Warrants

The number of shares issued for no consideration is added to the number of shares when calculating the DEPS.

A formula for DEPS with an option can be used to work out the number of free shares:

$$\text{No. of options} \times (\text{Fair value} - \text{exercise price}) / \text{Fair value}$$

## Diluted EPS : Importance

DEPS is important for the following reasons:

- it shows what the current year's EPS would be if all the dilutive potential ordinary shares in issue had been converted
- it can be used to assess trends in past performance

in theory, it serves as a warning to equity shareholders that the return on their investment may fall in future periods.

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## References

Financial Reporting (Fr) - Study Text, The Association Of Chartered Certified Accountants (ACCA). Kaplan Publishing

<https://www.iasplus.com/en/standards/ias/ias33>

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**Thank You**

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