

14

EARNINGS
PER SHARE

FINANCIAL REPORTING
STANDARD



ACCOUNTING
STANDARDS
BOARD

*Financial Reporting Standard 14
'Earnings per Share' is issued by
the Accounting Standards Board in respect
of its application in the United Kingdom
and by the Institute of Chartered
Accountants in Ireland in respect of its
application in the Republic of Ireland.*

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STANDARD

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Financial Reporting Standard 14 is set out in paragraphs 1-81.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraph 2 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix II 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS.

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ADOPTION OF FRS 14 BY THE BOARD

APPENDICES

- I COMPLIANCE WITH
INTERNATIONAL ACCOUNTING STANDARDS**

- II THE DEVELOPMENT OF THE FRS**

SUMMARY

General

- a Financial Reporting Standard 14 prescribes the basis for calculating and presenting earnings and other amounts per share in the financial statements of entities whose shares are, or will be, publicly traded and other entities that choose to disclose amounts per share.

Basic earnings per share

- b Basic earnings per share is a measure of past performance, calculated by dividing the net profit or loss attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period. In most cases, shares are included in the weighted average number of shares from the date consideration is receivable.
- c The FRS prescribes the methods by which the weighted average number of shares should be adjusted in respect of events that, without a corresponding change in resources, change the number of ordinary shares outstanding. Such events include bonus issues, bonus elements in other issues (for example rights issues), share splits and share consolidations. Where these events occur after the balance sheet date but before the date of approval of the financial statements all amounts presented per share should be based on the number of shares outstanding after the event.

Diluted earnings per share

- d Diluted earnings per share is similarly presented as a past performance measure while giving effect to potential ordinary shares outstanding during the period. The only potential ordinary shares to be included in the calculation of diluted earnings per share are those that are dilutive, ie those that, on conversion to ordinary shares, would decrease net profit per share or increase net loss from continuing operations. The FRS prescribes the sequence in which dilutive potential ordinary shares should be considered in determining the weighted average number of shares in the calculation of diluted earnings per share.
- e For the calculation of diluted earnings per share the net profit or loss attributable to ordinary shareholders is adjusted for the post-tax effects of amounts recognised in the period relating to dilutive potential ordinary shares that will no longer be incurred on their conversion to ordinary shares. Such amounts include, but are not restricted to, dividends on convertible equity instruments and interest in respect of convertible debt instruments.
- f The FRS provides detailed guidance on the application of the general principles underlying the calculation of diluted earnings per share to contingently issuable shares and options granted under employee share schemes.

Presentation and disclosure

- g** Figures for basic and diluted earnings per share are required to be presented on the face of the profit and loss account in respect of each class of ordinary share that has a different right to share in the profit or loss of the period.
- h** The numerators of the calculations presented should be disclosed and reconciled to the net profit or loss for the period. The denominators should also be disclosed and reconciled to each other.
- i** The FRS acknowledges the disclosure of other amounts per share and retains the disclosure requirements of FRS 3 'Reporting Financial Performance' in respect of these additional computations.

FINANCIAL REPORTING STANDARD 14

Objective

- 1 The objective of this FRS is to improve the comparison of the performance of different entities in the same period and of the same entity in different accounting periods by prescribing methods for determining the number of shares to be included in the calculation of earnings per share and other amounts per share and by specifying their presentation.

Definitions

- 2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

Equity instrument:-

Any instrument that evidences an ownership interest in an entity, ie a residual interest in the assets of the entity after deducting all of its liabilities.

Fair value:-

The amount at which a financial instrument could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.

Financial instrument:-

Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Ordinary share:-

An instrument falling within the definition of equity shares as defined in FRS 4 'Capital Instruments'.

Ordinary shares participate in the net profit for the period only after any other types of shares such as preference shares. An entity may have more than one class of ordinary shares. Ordinary shares of the same class will have the same rights to receive dividends.

Potential ordinary share:-

A financial instrument or a right that may entitle its holder to ordinary shares.

Examples of potential ordinary shares are:

- (a) debt or equity instruments, including preference shares, that are convertible into ordinary shares;
- (b) share warrants and options;
- (c) rights granted under employee share plans that may entitle employees to receive ordinary shares as part of their remuneration and similar rights granted under other share purchase plans; and
- (d) rights to ordinary shares that are contingent upon the satisfaction of certain conditions resulting from contractual arrangements, such as the purchase of a business or other assets, ie contingently issuable shares.

Warrants or options:-

Financial instruments that give the holder the right to purchase or subscribe for ordinary shares.

Scope

- 3 **The FRS applies to entities whose ordinary shares or potential ordinary shares are publicly traded and to entities that are in the process of issuing ordinary shares or potential ordinary shares in public securities markets.**
- 4 **When both the parent's and consolidated financial statements are presented, the disclosures called for by the FRS are required only on the basis of consolidated information.**
- 5 Users of the financial statements of a parent entity are usually concerned with, and need to be informed about, the results of operations of the group as a whole. Therefore, when both the parent's and consolidated financial statements are prepared, the information required by the FRS need be given only on the basis of the consolidated financial statements.
- 6 **An entity that has neither ordinary shares nor potential ordinary shares that are publicly traded, but discloses earnings per share, should calculate and disclose earnings per share in accordance with the FRS.**
- 7 An entity that has neither ordinary shares nor potential ordinary shares that are publicly traded is not required to disclose earnings per share. However, comparability in financial reporting among entities is maintained if any such entity that chooses to disclose earnings per share calculates it in accordance with the principles in the FRS.

- 8 The focus of the FRS is on the denominator of the earnings per share calculation. Although earnings per share data have limitations because of different accounting policies used for determining ‘earnings’, a consistently determined denominator enhances financial reporting. The provisions of the FRS are drafted principally in terms of amounts per share as components of net profit; however, the requirements also apply, as far as appropriate, to other amounts per share, eg net assets per share.

MEASUREMENT: BASIC EARNINGS PER SHARE

- 9 **Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.**

Earnings—basic

- 10 **For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to ordinary shareholders should be the net profit or loss for the period after deducting dividends and other appropriations in respect of non-equity shares.**
- 11 All items of income and expense that are recognised in a period, including tax expense, exceptional and extraordinary items and minority interests, are included in the determination of the net profit or loss for the period. The net profit or loss for the period attributable to ordinary shareholders is determined after taking account of appropriations in respect of non-equity shares, which include, but are not restricted to, preference dividends as detailed in FRS 4.

- 12 The amount of preference dividends that is deducted from the net profit for the period is:
- (a) the amount of any preference dividends on non-cumulative preference shares declared in respect of the period; and
 - (b) the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been declared, as the undeclared amount is still deductible as an appropriation. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.
- 13 Where an entity has more than one class of ordinary shares the earnings for the period are apportioned over the different classes of shares in accordance with their dividend rights or other rights to participate in profits.

Number of shares—basic

- 14 **For the purpose of calculating basic earnings per share, the number of ordinary shares should be the weighted average number of ordinary shares outstanding during the period.**

- 15 The weighted average number of ordinary shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares being outstanding at any time. It is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor. The time-weighting factor is the number of days that the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Example 1 - Weighted average number of shares

		<i>Shares issued</i>	<i>Own shares acquired *</i>	<i>Shares outstanding</i>
1 January 20X1	Balance at beginning of year	2,000	300	1,700
31 May 20X1	Issue of new shares for cash	800	-	2,500
1 December 20X1	Purchase of shares for cash	-	250	2,250
31 December 20X1	Balance at end of year	<u>2,800</u>	<u>550</u>	<u>2,250</u>

Computation of weighted average

$(1,700 \times 5/12) + (2,500 \times 6/12) + (2,250 \times 1/12) = 2,146$ shares

or

$(1,700 \times 12/12) + (800 \times 7/12) - (250 \times 1/12) = 2,146$ shares

**** Note: In the UK, at the date of issue of the FRS, the Government is consulting on whether own shares bought back should continue to be cancelled on acquisition.***

- 16 Company shares in issue that are held by a group member and are not cancelled are to be treated as if they were cancelled for earnings per share purposes and excluded from the calculation. Shares that are held by an employee share ownership plan (ESOP) trust and reflected in the company balance sheet as assets of the company are similarly to be treated as if they were cancelled for this purpose until such time as they vest unconditionally in the employees.
- 17 In most cases, shares are included in the weighted average number of shares from the date consideration is receivable (which is generally the date of their issue), for example:
- (a) ordinary shares issued in exchange for cash are included when cash is receivable;
 - (b) ordinary shares issued on the voluntary reinvestment of dividends on ordinary or preference shares are included at the dividend payment date;
 - (c) ordinary shares issued as a result of the conversion of a debt instrument to ordinary shares are included as of the date when interest ceases accruing;
 - (d) ordinary shares issued in place of interest or principal on other financial instruments are included as of the date when interest ceases accruing;
 - (e) ordinary shares issued in exchange for the settlement of a liability of the entity are included as of the settlement date; and
 - (f) ordinary shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised.

In these and other cases the timing of the inclusion of ordinary shares is determined by the specific terms and conditions attaching to their issue. Due consideration is given to the substance of any contract associated with the issue.

- 18 Ordinary shares issued as part of the purchase consideration of a business combination that is an acquisition are included in the weighted average number of shares as of the date of the acquisition because the acquirer incorporates the results of the operations of the acquired entity into its profit and loss account as from that date. Ordinary shares issued as part of a business combination that is merger accounted under FRS 6 'Acquisitions and Mergers' are included in the calculation of the weighted average number of shares for all periods presented because the financial statements of the combined entity are prepared as if the combined entity had always existed. Therefore, the number of ordinary shares used for the calculation of basic earnings per share in a business combination that is merger accounted under FRS 6 is the aggregate of the weighted average number of shares of the combined entities, adjusted to equivalent shares of the entity whose shares are outstanding after the combination.
- 19 Where ordinary shares are issued in partly paid form, they are treated as a fraction of an ordinary share to the extent that they were entitled to participate in dividends relative to a fully paid up ordinary share during the period.

- 20 Ordinary shares that are issuable upon the satisfaction of certain conditions (contingently issuable shares) are not included in the computation of basic earnings per share until all necessary conditions have been satisfied. In effect, this will be when issuing the shares is no longer contingent and when there is no circumstance under which the shares would not be issued. An illustration of this principle is included in example 6.
- 21 **The weighted average number of ordinary shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding, without a corresponding change in resources.**
- 22 Ordinary shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:
- (a) a bonus issue;
 - (b) a bonus element in any other issue or buy-back, for example a bonus element in a rights issue to existing shareholders or a put warrant, involving the repurchase of shares at significantly more than their fair value;
 - (c) a share split; and
 - (d) a share consolidation.

Bonus issues

- 23 In a bonus issue or a share split, 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. The number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period reported. As illustrated in example 2, on a two-for-one bonus issue, the number of shares outstanding before the issue is multiplied by three to obtain the new total number of shares, or by two to obtain the number of additional shares.

Example 2 - Bonus issue

Net profit 20X0	£180	
Net profit 20X1	£225	
Ordinary shares outstanding until 30 September 20X1	600	
Bonus issue 1 October 20X1	Two ordinary shares for each ordinary share outstanding at 30 September 20X1	
	600×2	$= 1,200$
Earnings per share 20X1	$\frac{£225}{(600+1,200)}$	$= 12.5p$
Adjusted earnings per share 20X0	$\frac{£180}{(600+1,200)}$	$= 10p$

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred before the beginning of 20X0, the earliest period reported.

Rights issues

- 24 The issue of ordinary shares at the time of exercise or conversion of potential ordinary shares will not usually give rise to a bonus element, since the potential ordinary shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the entity. In a rights issue, the exercise price is often less than the fair value of the shares. Therefore, such a rights issue includes a bonus element as indicated in paragraph 22(b) above. The number of ordinary shares to be used in calculating basic earnings per share for all periods before the rights issue is the number of ordinary shares outstanding before the issue, multiplied by the following factor:

$$\frac{\text{Fair value per share immediately before the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately before the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. This is illustrated in example 3. Where the rights themselves are to be publicly traded separately from the shares before the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Example 3 - Rights issue

Net profit at 31 December	20X0: £30,000; 20X1: £38,000; 20X2: £45,000
Shares outstanding before rights issue	500,000
Rights issue	One new share for each five outstanding (100,000 new shares total) Exercise price: £5.00 Last date to exercise rights: 1 March 20X1
Fair value of one ordinary share immediately before exercise on 1 March 20X1	£11.00

Computation of theoretical ex-rights value per share

Fair value of all outstanding shares	+	total amount received from exercise of rights
Number of shares outstanding before exercise	+	number of shares issued in the exercise

$$\frac{(\pounds 11.00 \times 500,000 \text{ shares}) + (\pounds 5.00 \times 100,000 \text{ shares})}{500,000 \text{ shares} + 100,000 \text{ shares}}$$

$$\text{Theoretical ex-rights value per share} = \pounds 10.00$$

Computation of adjustment factor

$$\frac{\text{Fair value per share before exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\pounds 11.00}{\pounds 10.00} = 1.1$$

Computation of earnings per share

	<u>20X0</u>	<u>20X1</u>	<u>20X2</u>
20X0 EPS as originally reported: £30,000/500,000 shares	6p		
20X0 EPS restated for rights issue: £30,000/(500,000 shares x 1.1)	5.4p		
20X1 EPS including effects of rights issue: £38,000			
<u>(500,000 x 1.1 x 2/12) + (600,000 x 10/12)</u>		6.4p	
20X2 EPS £45,000/600,000 shares			7.5p

Share consolidations

- 25 A consolidation of shares reduces the number of ordinary shares outstanding without a reduction in resources. The number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period reported.
- 26 No adjustment is made to the number of ordinary shares outstanding before the event where a share consolidation is combined with a special dividend and the overall commercial effect in terms of net assets, earnings and number of shares is of a repurchase at fair value. As no such adjustment is required for the share repurchase, it is not appropriate in this instance to make an adjustment for the share consolidation, which is but one part of the larger event. The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of shares in issue from the date the special dividend is paid, ie when resources leave the entity.

MEASUREMENT: DILUTED EARNINGS PER SHARE

- 27 **For the purpose of calculating diluted earnings per share, the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding should be adjusted for the effects of all dilutive potential ordinary shares.**
- 28 The calculation of diluted earnings per share is consistent with the calculation of basic earnings per share while giving effect to all dilutive potential ordinary shares that were outstanding during the period.

Number of shares—diluted

- 29 **For the purpose of calculating diluted earnings per share, the number of ordinary shares should be the weighted average number of ordinary shares calculated in accordance with paragraphs 14 and 21, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Potential ordinary shares should be deemed to have been converted into ordinary shares at the beginning of the period or, if not in existence at the beginning of the period, the date of the issue of the financial instrument or the granting of the rights by which they are generated.**
- 30 As explained in paragraph 2, such financial instruments or rights include, but are not restricted to, the following examples, in respect of which specific guidance is provided in the paragraphs as indicated:
- (a) convertible debt or equity instruments;
 - (b) share warrants and options (paragraphs 35-38);
 - (c) rights granted under employee or other share purchase plans (paragraphs 39-44); and
 - (d) rights to ordinary shares that are contingent upon the satisfaction of certain conditions resulting from contractual arrangements, such as the purchase of a business or other assets, ie contingently issuable shares (paragraphs 45-52).

- 31 The number of ordinary shares that would be issued on the conversion of dilutive potential ordinary shares is determined from the terms of the financial instrument or rights through which they are generated. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.
- 32 If an entity issues a contract that may be settled in shares or in cash at the election of the recipient or the issuer, whether that contract is reflected in the calculation of diluted earnings per share is based on the facts available each period. If past experience or a stated policy provides a reasonable basis for concluding how the contract will be satisfied, that policy or experience is followed. Where there is no stated policy and the entity has no past experience of settling such contracts it is presumed that the contract will be settled by the more dilutive method. The resulting potential ordinary shares are included in diluted earnings per share, in accordance with the relevant provisions of the FRS.
- 33 A subsidiary, joint venture or associate may issue potential ordinary shares that are exchangeable for either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the reporting entity. If these potential ordinary shares of the subsidiary, associate or joint venture would, on conversion, have a dilutive effect on the consolidated basic earnings per share of the reporting entity, they are included in the calculation of diluted earnings per share.
- 34 To the extent that partly paid shares are not entitled to participate in dividends during the financial period they are regarded as the equivalent of share warrants or options.

Share warrants and options

- 35 **For the purpose of calculating diluted earnings per share, an entity should assume the exercise of dilutive options and other dilutive potential ordinary shares of the entity. The assumed proceeds from these issues should be regarded as having been received from the issue of shares at fair value. The difference between the number of shares issued and the number of shares that would have been issued at fair value should be treated as an issue of ordinary shares for no consideration.**
- 36 Fair value for this purpose is calculated on the basis of the average price of the ordinary shares during the reporting period.
- 37 Options and other share purchase arrangements are dilutive when they would result in the issue of ordinary shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement, as illustrated in example 4, is treated as consisting of:
- (a) a contract to issue a certain number of ordinary shares at their average fair value during the period. The shares so to be issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and
 - (b) a contract to issue the remaining ordinary shares for no consideration. Such ordinary shares generate no proceeds and have no effect on the net profit attributable to ordinary shares outstanding. Therefore such shares are dilutive and they are added to the number of ordinary shares outstanding in the calculation of diluted earnings per share.

Example 4 - Effects of share options on diluted earnings per share

Net profit for year 20X1 £1,200,000

Weighted average number of
ordinary shares outstanding
during 20X1 5 million

Average fair value of one
ordinary share during
year 20X1 £4.00

Weighted average number of
shares under option during
year 20X1 1 million

Exercise price for shares under
option during year 20X1 £3.00

Computation of earnings per share

	<i>per share</i>	<i>earnings</i>	<i>shares</i>
Net profit for year 20X1		£1,200,000	
Weighted average shares outstanding during year 20X1			5m
<i>Basic earnings per share</i>	24p		
Number of shares under option			1m
Number of shares that would have been issued at fair value:			
(1 million x £3.00) / £4.00		*	(0.75m)
<i>Diluted earnings per share</i>	22.9p	£1,200,000	5.25m

*Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (250,000) deemed for the purpose of the computation to have been issued for no consideration (see paragraph 37(b))

- 38 This method of calculating the effect of options and other share purchase arrangements produces the same result as the treasury stock method that is used in some countries. This does not imply that the entity has entered into a transaction to purchase its own shares, which may not be practicable in certain circumstances or legal in some jurisdictions.

Employee share and incentive plans

- 39 Share option and other incentive schemes are an increasingly common feature of employee remuneration, generating potential ordinary shares that require particular consideration in the calculation of diluted earnings per share.
- 40 Incentive schemes and their detailed structures may adopt one of many forms. For the purpose of diluted earnings per share, however, a distinction is made only between incentive schemes in which awards are based on performance criteria, and other schemes. Performance-based awards are to be treated as contingently issuable shares, since their issue or exercise is contingent upon factors other than the passing of time, such as the level of future earnings. Such awards are accounted for in accordance with the provisions of paragraphs 45-52.
- 41 All other awards made under an employee share or other incentive scheme are regarded as options for the purpose of calculating diluted earnings per share. They are to be regarded as outstanding as of the grant date even though their exercise may be contingent upon vesting. They are to be included in the computation even if the employee may not receive (or be able to sell) the shares until some future date. Accordingly, all shares to be issued are included in calculating diluted earnings per share if the effect is dilutive. Where the awards are granted during the period, the shares to be issued are weighted to reflect that fact.

- 42 The dilutive effect of the options is to be calculated using the method as set out in paragraph 37 and illustrated in example 4. In applying that method, the assumed proceeds of the potential ordinary shares may need to be adjusted to reflect the fact that they have been earned by past services. This will be the case for those schemes to which UITF Abstract 17 'Employee share schemes' is applied and which are not considered as contingently issuable shares. Here, as illustrated in example 5, the assumed proceeds consist of the consideration, if any, the employee must pay upon exercise of the award and the cost of the shares calculated in accordance with UITF 17 but not yet recognised. Initially, dilution is less because part of the consideration consists of future services not yet received. It becomes greater, over time, as the entity's earnings reflect the benefits of having received those services.
- 43 When adjusting net profit for the purpose of diluted earnings per share in accordance with paragraphs 53-55, no adjustment is permitted in respect of the UITF 17 charge to the profit and loss account as the charge represents a cost of issuing the potential ordinary shares that would not be saved on conversion.
- 44 If employee share arrangements may be satisfied by the purchase of shares in the market or cash, the determination of whether such awards are potential ordinary shares is made in accordance with the provisions of paragraph 32.

Example 5 - Share option scheme not related to performance

Company A has in place an employee share option scheme that awards share options to employees and their dependants on the basis of period of service with the company.

The provisions of the scheme are as follows at the 20X0 year-end.

Date of grant	1 January 20X0
Market price at grant date	£4.00
Exercise price of option	£2.50
Date of vesting	31 December 20X2
Number of shares under option	1 million

Applying UITF 17, the profit and loss account is charged with 50p per option in each of the three years 20X0–20X2.

Net profit for year 20X0	£1,200,000
Weighted average number of ordinary shares outstanding	5 million
Average fair value of an ordinary share during the year	£5.00
Assumed proceeds per option	£3.50 (exercise price of £2.50 and compensation cost attributable to future service, not yet recognised, of £1.00). Next year £3.00 (ie £2.50 plus 50p).

Computation of earnings per share

	<i>per share</i>	<i>earnings</i>	<i>shares</i>
Net profit for year 20X0		£1,200,000	
Weighted average shares outstanding for 20X0			5m
<i>Basic earnings per share</i>	24p		
Number of shares under option			1m
Number of shares that would have been issued at fair value: (1 million x £3.50) / £5.00			(0.7m)
<i>Diluted earnings per share</i>	22.6p	£1,200,000	5.3m

Contingently issuable shares

- 45 Contingently issuable shares are included in the calculation of diluted earnings per share as of the beginning of the period (or, if not in existence at the beginning of the period, from the date of the relevant financial instrument or the granting of the rights).
- 46 The number of contingently issuable shares to include in the calculation is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. The diluted earnings per share computation includes those shares that would be issued under the terms of the contingency on the assumption that the current amount of earnings or status of the condition, as appropriate, were to remain unchanged until the end of the agreement, if the effect is dilutive. Where a condition is expressed as an average over a period it has the same effect as if it were expressed as a cumulative amount over the period—the performance achieved to date is deemed to be that achieved over the whole of the contingency period. For example, if the number of shares to be issued depends on whether profits average £100,000 over a three-year period, the condition is expressed in terms of a cumulative target of £300,000 over the three-year period. If, at the end of the first year, profits are £150,000, no additional shares are brought into the calculation.

- 47 Where the number of shares that may be issued in the future depends upon the market price of the shares of the issuing company, the number of shares to be included in the calculation of diluted earnings per share, if dilutive, is based on the number that would be issued, based on the current market price at the end of the current reporting period or the average over a specified period, depending on the terms of the underlying contract.
- 48 For deferred consideration agreements, in which the consideration is fixed but the number of shares issuable is not known, the number of shares to be included in the calculation is based on the market price at the balance sheet date as if it were the end of the contingency period.
- 49 If the contingency is based on a condition other than earnings or market price, the contingently issuable shares are included on the assumption that the status of the condition at the end of the reporting period will remain unchanged until the end of the contingency period. For example, if a further issue of shares is generated on the opening of the tenth new retail outlet and at the year-end only five have been opened, no contingently issuable shares are included in the diluted earnings per share computation.
- 50 Where the number of shares that may be issued depends upon any combination of future events, the number to be included is based on the status of all relevant conditions at the end of the reporting period. No shares are included where one of the conditions is not met.

- 51 Paragraphs 45–50 also apply to contingently issuable potential ordinary shares such as share options, warrants or convertibles. If they are to be reflected in the calculation of diluted earnings per share they are included in accordance with the relevant provisions of the FRS. Where an entity has contingently issuable potential ordinary shares (for example, contingently issuable warrants) in respect of the same class of ordinary shares and on the same terms as warrants etc currently in issue, then, for consistency, the former may be included in the diluted earnings per share calculation only if conversion or exercise of the warrants etc already in issue is also assumed.
- 52 Consistently with the general principle set out in paragraph 65, restatement of prior period diluted earnings per share figures is not permitted if the conditions are not met when the contingency period expires.

Example 6 - Contingently issuable shares

Company A has 1 million ordinary shares outstanding at 1 January 20X0. The terms of a deferred consideration agreement, related to a recent business acquisition, provide for the following contingently issuable shares:

- 20,000 additional ordinary shares for every new retail outlet opened in each of the three years 20X0 –20X2.
- 2,000 additional ordinary shares for each £1,000 of total net income in excess of £700,000 over the three years ending 20X2.

(Assume for example purposes that any additional shares are issued on 1 January in the accounting period following that in which a condition is met.)

continued

Example 6 - continued

Company A opened one new retail outlet on 1 April 20X0 and another on 1 February 20X2.

Company A reported net income for the three years of £300,000, £475,000 and £350,000 respectively.

Computation of basic EPS

	<u>20X0</u>	<u>20X1</u>	<u>20X2</u>
	£	£	£
Numerator	<u>300,000</u>	<u>475,000</u>	<u>350,000</u>
Denominator			
Ordinary shares	1,000,000	1,020,000 ^c	1,020,000
Retail outlet contingency	15,000 ^a	—	18,333 ^e
Earnings contingency	— ^b	— ^d	— ^d
Total shares	<u><u>1,015,000</u></u>	<u><u>1,020,000</u></u>	<u><u>1,038,333</u></u>
<i>Basic EPS</i>	29.6p	46.6p	33.7p

Computation of diluted EPS

	<u>20X0</u>	<u>20X1</u>	<u>20X2</u>
	£	£	£
Numerator	<u>300,000</u>	<u>475,000</u>	<u>350,000</u>
Denominator			
Ordinary shares in basic EPS	1,015,000	1,020,000	1,038,333
Additional shares for:			
Retail outlet contingency	5,000 ^f	—	1,667 ^f
Earnings contingency	— ^g	150,000 ^h	850,000 ⁱ
Total shares	<u><u>1,020,000</u></u>	<u><u>1,170,000</u></u>	<u><u>1,890,000</u></u>
<i>Diluted EPS</i>	29.4p	40.6p	18.5p

continued

Example 6 - continued

- a $20,000 \times 9/12$
- b In 20X0, the earnings contingency has no effect on basic EPS because the condition is not satisfied. (See also d below.)
- c In 20X1, shares relating to the retail outlet opened on 1 April 20X0 are included in basic EPS from their date of issue.
- d In 20X1 and 20X2, the earnings contingency has no effect on basic EPS because it is not certain that the condition is met until the last day of the three-year period. (See also i below.)
- e $11/12 \times 20,000$
- f Additional shares included in diluted EPS, which includes contingently issuable shares from the beginning of the period.
- g Company A did not have £700,000 net income at 31 December 20X0.
- h $(£775,000 - £700,000)/1,000 \times 2,000$
- i $(£1,125,000 - £700,000)/1,000 \times 2,000$. The shares will be included in basic EPS as from 1 January 20X3, their date of issue.

Earnings—diluted

53 For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to ordinary shareholders, as calculated in accordance with paragraph 10, should be adjusted by the post-tax effect of :

- (a) any dividends on dilutive potential ordinary shares that have been deducted in arriving at the net profit attributable to ordinary shareholders as calculated in accordance with paragraph 10;**

- (b) interest recognised in the period for the dilutive potential ordinary shares; and**
- (c) any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.**

54 After the dilutive potential ordinary shares are converted into ordinary shares, the dividends, interest and other income or expense associated with the financial instrument or rights through which they are generated will no longer be incurred. Instead, the new ordinary shares will be entitled to participate in the net profit attributable to ordinary shareholders. Therefore, the net profit for the period attributable to ordinary shareholders calculated in accordance with paragraph 10 is increased by the amount of dividends, interest and other income or expense that will be saved on the conversion into ordinary shares. This principle is illustrated in example 7 in respect of convertible bonds. The expenses associated with potential ordinary shares include fees and discount or premium that are allocated to periods over their term at a constant rate. The amounts of dividends, interest and other income or expense are adjusted for any tax effects, borne by the entity, that are attributable to them.

Example 7 - Convertible bonds

Net profit	£1,000
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Ordinary shares outstanding	10,000
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Basic earnings per share	10p
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Convertible 10% bonds	1,000
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Each block of 10 bonds is convertible into 15 ordinary shares

Interest expense for the current year relating to the liability component of the convertible bond	£100
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Current and deferred tax relating to that interest expense	£40
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Note: the interest expense includes amortisation of the discount arising on initial recognition of the liability component (see FRS 4)

Adjusted net profit	$£1,000 + £100 - £40 = £1,060$
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Number of ordinary shares resulting from conversion of bond	1,500
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Number of ordinary shares used to compute diluted earnings per share	$10,000 + 1,500 = 11,500$
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Diluted earnings per share	$\frac{£1,060}{11,500} = 9.2\text{p}$
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- 55 The conversion of some potential ordinary shares may lead to consequential changes in other income or expenses. For example, the reduction of interest expense related to convertible debt instruments and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit-sharing plan. For the purpose of calculating diluted earnings per share, the net profit or loss for the period is adjusted for any such consequential changes in income or expense.

Dilutive potential ordinary shares

- 56 **For the purpose of calculating diluted earnings per share, the net profit attributable to ordinary shareholders and the weighted average number of shares should be adjusted for the effects of dilutive potential ordinary shares. Potential ordinary shares should be treated as dilutive when, and only when, their conversion to ordinary shares would decrease net profit or increase net loss per share from continuing operations.**
- 57 An entity takes net profit from continuing operations as the 'control number' that is used to establish whether potential ordinary shares are dilutive, ie whether conversion would reduce or increase basic earnings per share from continuing operations. The effects of antidilutive potential ordinary shares are ignored in calculating diluted earnings per share.
- 58 The net profit from continuing operations is the net profit from continuing operations after deducting preference dividends and other appropriations in respect of non-equity shares and after excluding items relating to discontinued operations and extraordinary items.

- 59 FRS 3 'Reporting Financial Performance' requires an analysis of continuing operations, acquisitions (as a component of continuing operations) and discontinued operations only to the level of profit before interest, because interest payable often reflects an entity's overall financing policy rather than an aggregation of the particular types of finance allocated to its operations. Although FRS 3 does not encourage further allocation without disclosure of the method and underlying assumptions adopted, many entities will have the data necessary to allocate interest and tax between continuing and discontinued operations. In particular, it will often be possible to allocate a specific amount of tax and interest to exceptional items that are reported after operating profit under paragraph 20 of FRS 3. Where practicable, such an allocation is adopted for determination of the 'control number'.
- 60 In the absence of a practical, more reliable method of allocation, however, net profit from continuing operations will need to be estimated. In these restricted circumstances, and following any specific allocation of tax and interest that may be possible in respect of exceptional items shown after operating profit, it is permitted to allocate interest and taxation in the proportion of profit from continuing operations to total profit at the operating profit level. In practice a profit-based allocation method may be more suitable for taxation, which is levied on profits, than for interest, which finances capital.
- 61 In considering whether potential ordinary shares are dilutive or antidilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which potential ordinary shares are considered may affect whether they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive as illustrated in example 8.

Example 8 - Determining the order in which to include dilutive securities in the calculation of weighted average number of shares

Earnings - net profit attributable to ordinary shareholders	£12 million
Net profit attributable to discontinued operations	£2 million
Ordinary shares outstanding	20 million
Average fair value of one ordinary share during year	£7.50

Potential ordinary shares

Options	5 million with exercise price of £6
Convertible preference shares	800,000 entitled to a cumulative dividend of £8 per share. Each is convertible to two ordinary shares.
2% Convertible bond	nominal amount £100 million. Each £1,000 bond is convertible to 40 ordinary shares. There is no amortisation of premium or discount affecting the determination of interest expense.
Tax rate	40%

Determining the increase in earnings attributable to ordinary shareholders on conversion of potential ordinary shares

	Increase in earnings £	Increase in number of ordinary shares	Earnings per incremental share £
<i>Options</i>			
Increase in earnings	NIL		
Incremental shares issued for no consideration 5 million x (£7.5-£6)/£7.5		1,000,000	NIL
<i>Convertible preference shares</i>			
Increase in net profit £8 x 800,000	6,400,000		
Incremental shares 2 x 800,000		1,600,000	4.00
<i>2% Convertible bonds</i>			
Increase in net profit £100,000,000 x 0.02 x (1-0.4)	1,200,000		
Incremental shares 100,000 x 40		4,000,000	0.30

continued

Example 8 - continued***Determining the potential ordinary shares to include in the computation of diluted earnings per share***

	<i>Net profit attributable to continuing operations</i>	<i>Ordinary shares</i>	<i>Per share</i>
	£	Number	£
As reported	10,000,000	20,000,000	0.50
Options*	—	1,000,000	
	10,000,000	21,000,000	0.48 Dilutive
2% Convertible bonds	1,200,000	4,000,000	
	11,200,000	25,000,000	0.45 Dilutive
Convertible preference shares	6,400,000	1,600,000	
	17,600,000	26,600,000	0.66 Antidilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from 45p to 66p), the convertible preference shares are antidilutive and are ignored in the calculation of diluted earnings per share.

Computation of basic earnings per share:

Net profit	£12 million
Weighted average number of shares outstanding	20 million
<i>Basic earnings per share</i>	60p

Computation of diluted earnings per share:

Net profit (£12m plus £1.2m convertible bond interest)	£13.2 million
Weighted average number of shares outstanding	25 million
<i>Diluted earnings per share</i>	52.8p

* The potential share issues are considered in order from the most to the least dilutive.

- 62 Potential ordinary shares are weighted for the period they were outstanding. Potential ordinary shares that were cancelled or allowed to lapse during the reporting period are included in the calculation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential ordinary shares that have been converted into ordinary shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.

Restatement

- 63 **If the number of ordinary or potential ordinary shares outstanding is changed by events, other than the conversion of potential ordinary shares, without a corresponding change in resources—for example, those referred to in paragraph 22—the calculation of basic and diluted earnings per share for all periods presented should be adjusted retrospectively. If these changes occur after the balance sheet date but before the date of approval of the financial statements, the calculations per share for the financial statements and those of any prior period should be based on the new number of shares. When calculations per share reflect such changes in the number of shares, that fact should be stated. In addition, basic and diluted earnings per share of all periods presented should be adjusted for the effects of a business combination that is merger accounted under FRS 6.**

- 64 No adjustment of prior periods' earnings per share should be made in respect of a share consolidation combined with a special dividend, where, as described in paragraph 26, the overall commercial effect is that of a share repurchase at fair value. Where this provision applies, that fact should be stated.**
- 65 Diluted earnings per share of any prior period presented should not be restated for changes in the assumptions used or for the conversion of potential ordinary shares into ordinary shares outstanding.**
- 66 An entity should disclose a description of ordinary share transactions or potential ordinary share transactions, other than those accounted for in accordance with paragraph 63, that occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.**
- 67 Examples of such transactions include:
- (a) the issue of shares for cash;
 - (b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;
 - (c) the redemption of ordinary shares;
 - (d) the issue of potential ordinary shares;
 - (e) the buy-back of ordinary shares outstanding;
 - (f) the conversion of potential ordinary shares, outstanding at the balance sheet date, into ordinary shares; and

(g) the achievement of conditions that would result in the issue of contingently issuable shares.

- 68 Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because they do not affect the amount of capital used to produce the net profit or loss for the period.

Presentation

- 69 **An entity should present basic and diluted earnings per share on the face of the profit and loss account for each class of ordinary share that has a different right to share in the net profit for the period. An entity should present basic and diluted earnings per share with equal prominence for all periods presented.**
- 70 **An entity should present basic and diluted earnings per share, even if the amounts disclosed are negative (ie a loss per share).**

Additional disclosures

- 71 **An entity should disclose the following:**
- (a) **the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period; and**
 - (b) **the weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and, excepting figures given in respect of different classes of ordinary share, a reconciliation of these denominators to each other.**

- 72 Financial instruments and the granting of rights that generate potential ordinary shares may incorporate terms and conditions that affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether any potential ordinary shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the net profit attributable to ordinary shareholders. Whether or not the disclosure of the terms and conditions is required by FRS 4 such disclosure is encouraged by the FRS.
- 73 If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of net profit other than net profit or loss for the period attributable to ordinary shareholders, such amounts should be calculated using the weighted average number of ordinary shares determined in accordance with the FRS.**
- 74 Such additional earnings per share computations should be presented on a consistent basis over time and, wherever disclosed, reconciled to the amount required by the FRS. The reconciliation should list the items for which an adjustment is being made and disclose their individual effect on the calculation. The earnings per share required by the FRS should be at least as prominent as any additional version presented and the reason for calculating the additional version should be explained. The reconciliation and explanation should appear adjacent to the earnings per share disclosure, or a reference should be given to where they can be found. Where both additional basic and diluted amounts per share are presented, they should be disclosed with equal prominence.**

- 75 An entity may wish to disclose more information than the FRS requires. Such information may help the users to evaluate the performance of the entity and may take the form of amounts per share for various components of net profit. However, when such amounts are disclosed, the denominators are calculated in accordance with the FRS in order to ensure the comparability of the amounts per share disclosed.

Financial statistics in any historical summary

- 76 In order to give a fair comparison over the period of any historical summary presented, the basic and diluted earnings per share figures, consistently with the requirements of paragraph 63, need to be restated for subsequent changes in capital not involving full consideration at fair value (ie bonus issues, bonus elements in other issues or repurchases, share splits and share consolidations other than those combined with special dividends as described in paragraph 26). The cumulative effect of all such events is taken into account and the resultant earnings per share figures are described as restated and are clearly distinguished from other non-adjusted data.
- 77 Similarly, for comparison purposes, any record of equity dividends for the same period set out in the form of pence per share is adjusted by the factors applied when restating earnings per share as above. The equity dividends are described as restated and, with the restated earnings per share, are clearly distinguished from other non-adjusted data in the summary.

- 78 Dividend cover is normally found by dividing earnings by dividends. This simple relationship does not always apply as the payment of additional dividends may involve the company in the payment of further taxation either in the UK or overseas. Therefore, dividend cover is based on the theoretical maximum dividend from the current period's earnings, after allowing for such additional taxation, divided by the actual dividend.

Date from which effective

- 79 **The accounting practices set out in the FRS should be regarded as standard in respect of accounting periods ending on or after 23 December 1998. Earlier adoption is encouraged.**

Withdrawal of SSAP 3 and amendment of UITF Abstract 13

- 80 **The FRS supersedes SSAP 3 'Earnings per share'.**
- 81 **The FRS makes the following changes to UITF Abstract 13 'Accounting for ESOP Trusts':**
- (a) **Paragraph 7 is deleted and replaced with the following:**

“Dividend income arising on the shares should be excluded in arriving at profit before tax and deducted from the aggregate of dividends paid and proposed. Until such time as the shares vest unconditionally in employees, the shares should also be excluded from earnings per share calculations as, under FRS 14 'Earnings per Share', they are treated as if they were cancelled.”

(b) Paragraph 8(g) is deleted and replaced with the following:

“Any dividend income arising on the shares should be excluded in arriving at profit before tax and deducted from the aggregate of dividends paid and proposed. The deduction should be disclosed on the face of the profit and loss account, if material, or in a note. Until such time as the shares vest unconditionally in employees, the shares should also be excluded from earnings per share calculations as, under FRS 14 ‘Earnings per Share’, they are treated as if they were cancelled.”

(c) Under the heading ‘References and legal considerations’ the reference to paragraphs 14 and 15 of SSAP 3 ‘Earnings per share’ is deleted and replaced with the following:

“Financial Reporting Standard 14 ‘Earnings per Share’, paragraphs 69–71.”

ADOPTION OF FRS 14 BY THE BOARD

Financial Reporting Standard 14 - 'Earnings per Share' was approved for issue by the ten members of the Accounting Standards Board.

Sir David Tweedie (Chairman)

Allan Cook (Technical Director)

David Allvey

Ian Brindle

Dr John Buchanan

John Coombe

Raymond Hinton

Huw Jones

Professor Geoffrey Whittington

Ken Wild

APPENDIX I

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

- 1 For the reasons given in Appendix II ‘The development of the FRS’, the FRS adopts the proposals and similar text of the International Accounting Standards Committee’s standard IAS 33 ‘Earnings Per Share,’ which was published in February 1997 and which is operative for financial statements covering periods beginning on or after 1 January 1998.
- 2 There are the following differences.
 - If additional amounts per share are presented for components of profit other than a line item in the profit and loss account, IAS 33 requires a reconciliation to a line item. The FRS adopts the requirements in FRS 3 ‘Reporting Financial Performance’ that the additional amounts per share should be reconciled to the earnings per share figure required by FRS 14 and that the reconciliation should list the items for which adjustment is made, disclosing their individual effect on the calculation. The further disclosure requirements of FRS 3 regarding the explanation and presentation of additional amounts per share have also been incorporated into the FRS.
 - The FRS gives additional guidance in respect of the computation of ‘net profit from continuing operations’, which is used as the control number with which to establish whether potential ordinary shares are dilutive or antidilutive.

- The FRS provides specific guidance on how to treat, for earnings per share purposes, a special dividend combined with a share consolidation. IAS 33 does not address this issue.
- The FRS provides more guidance than IAS 33 on determining how to treat contingently issuable shares for earnings per share purposes. This guidance is compatible with that given in the US standard FAS 128 'Earnings per Share'.
- The FRS provides guidance on how to treat shares held in an employee share scheme for earnings per share purposes. This guidance is compatible with that given in FAS 128.
- The FRS includes additional guidance in respect of the presentation of financial statistics in historical summaries.

APPENDIX II

THE DEVELOPMENT OF THE FRS

History

- 1 SSAP 3 'Earnings per share' was originally introduced in February 1972 to satisfy the need for a standard accounting practice for the disclosure of earnings per share, based on the then increasing use of the price-earnings (PE) ratio as a common stock market indicator.
- 2 SSAP 3 was revised in August 1974 to reflect the change in the basis of taxation to the imputation system. The amended SSAP was adopted by the Accounting Standards Board in August 1990 upon succeeding its predecessor body, the Accounting Standards Committee.
- 3 The Board stated in FRS 3 'Reporting Financial Performance' that all components of an entity's activities should be considered when assessing its performance during a period. It advised against undue reliance on any single performance measure, emphasising that earnings per share, for example, which until then had been presented at the level of profit before extraordinary items, was only a starting point for analysis of corporate performance. FRS 3 virtually abolished extraordinary items and amended SSAP 3 accordingly.

- 4 It was expected that, no longer sheltered by extraordinary items, earnings per share would become more unpredictable and volatile. The Board believed that preparers would provide additional amounts per share that would assist in explaining the dynamics of their entity's performance. FRS 3 introduced disclosures to steer the way in which these additional amounts per share would be presented and included a requirement to explain why they had been disclosed.
- 5 The Board acknowledges that earnings per share is a widely used statistic in financial analysis. It believes that SSAP 3 as amended appears to be operating reasonably effectively and, were it not for international developments on the matter, would not be revising UK guidance on the subject at this time.

Discussion Paper

- 6 In October 1993 the International Accounting Standards Committee (IASC) issued a draft statement 'Earnings Per Share'. The following year the US Financial Accounting Standards Board (FASB) added to its technical agenda a project on earnings per share to be pursued concurrently with IASC, with the object of improving and simplifying US generally accepted accounting principles (GAAP) on the matter and issuing a standard that would be compatible with an international standard.
- 7 The exposure drafts, published early in 1996, showed that the FASB and IASC had reached agreement on many of the main points of principle, and indicated that the international standard would be much closer to the current UK requirements than to US GAAP.

- 8 The Board decided to issue a Discussion Paper on earnings per share to give the UK financial reporting community the opportunity of influencing the further development of the international proposals. With the permission of IASC it republished the full text of IASC's Exposure Draft (E52). The Board did not make any proposals on the various issues raised by E52 but noted a number of differences between the requirements of SSAP 3 and the international proposals and asked respondents for their preferences.

Comments on the main issues highlighted in the Discussion Paper

- 9 On those questions that contrasted the computational methods of SSAP 3 with the proposals of E52 most respondents preferred the IASC proposals. These included the basis of calculation of basic earnings per share, the method to be used when adjusting the weighted average number of shares for the effect of warrants and options and the manner of sequencing various issues of potential ordinary shares in determining whether they are dilutive. There was also support for the presentation of comparative figures and for disclosures relating to potential ordinary shares in issue at the year-end, which were intended to disclose the full effect of the risk attaching to basic earnings per share in the future.
- 10 By contrast, respondents generally preferred the current UK requirements to those proposed by E52 for disclosure in connection with the numerators and denominators applied in respect of basic and diluted earnings and other amounts per share.

- 11 The Board drew IASC's attention to some of the central issues and anomalies raised by UK respondents. When IASC issued International Accounting Standard (IAS) 33 'Earnings Per Share' in February 1997, a number of changes had been made to the proposals put forward in E52, certain of which reflected the views of the UK respondents. The standard also included other requirements, which had not been exposed in earlier documents and which the UK financial community had not had the opportunity of addressing.
- 12 In the light of comments received in respect of the Discussion Paper the Board thought it sensible to support the move towards harmonisation on earnings per share by implementing the international standard in the UK.

FRED 16

- 13 Given the primary motivation for the project, the Board saw little merit in making unnecessary changes to the requirements of the international standard. For that reason, it adopted the proposals, and with minimal exceptions, the text, of IAS 33 in its Exposure Draft, FRED 16 'Earnings per Share'. The specific matters on which respondents' views were sought concentrated on the acceptability of the international standard in the UK.
- 14 Respondents to FRED 16 were largely in agreement that the general principles and the required methodology, computation and presentation of IAS 33 should be adopted by the Board. However, there was a strong feeling, variously expressed, that there should

be a greater degree of customisation of the international standard than had been presented in the FRED to minimise inconsistencies with existing UK law and standards and to allow the proposals to sit more comfortably within the UK reporting framework. This view was accepted by the Board, within the restrictions of its decision not to make unnecessary changes to the IASC requirements.

Objectives of diluted earnings per share

- 15 IAS 33 does not define objectives either for basic or for diluted earnings per share. Whereas in E52 IASC had attempted to accommodate both a historical and a forward-looking objective for diluted earnings per share, the eventual standard abandoned the attempt to satisfy a dual function. IAS 33 does not reflect the notion that diluted earnings per share can function as a warning-signal of the variability of the risk attaching to basic earnings per share as a consequence of the number of potential ordinary shares in issue. The standard is drafted on the basis that diluted earnings per share is an additional past performance measure, consistent with that of basic earnings per share while giving effect to all dilutive potential ordinary shares. The decision of IASC not to acknowledge a forward-looking function for diluted earnings per share affects the detail of certain of the computations. It explains, for example, why fair value, for the purpose of share warrants and share options, is calculated on the basis of the average price of an ordinary share for the period rather than the period-end market price.

Control number for determining diluted earnings per share

- 16 E52 had stipulated that 'net profit' should function as the control number for determining whether potential ordinary shares are dilutive. The final standard introduced the concept of 'net profit from continuing ordinary operations' as the control number. FRS 3 does not require reporting entities to allocate components of the profit and loss account beyond the level of operating profit. FRED 16 therefore proposed, but only in the absence of a more reliable method, that such an allocation might be made in the proportion of profit from continuing operations to total profit at operating profit level.
- 17 Respondents expressed a variety of views on this matter. Some expressed reservations about the original requirement as set out in IAS 33. They recognised the logic in choosing, as a control number, one that would be reasonably consistent over time and reflect the earnings that will exist in the future when the dilution occurs and when the net return from discontinued operations is likely to be a loss. As respondents pointed out, however, this implies a predictive function for diluted earnings per share that is at odds with the approach taken elsewhere in the standard.
- 18 Others disagreed with the UK proposal on the basis that it encouraged or rather required a method of allocation for the computation of earnings per share that is expressly discouraged in FRS 3 for general reporting purposes. Several respondents suggested that the earnings figure would be a more appropriate control number. The distinct disadvantage to this proposal is that it would be much more likely to fluctuate between a net profit one year and a net loss

the next with a consequential effect on the consistency with which any particular issue of potential ordinary shares could be regarded as dilutive or antidilutive. Others took the view that although FRS 3 does not encourage such an allocation, many companies have the necessary data to make a reasonably accurate allocation of tax and interest and should be encouraged to do so.

- 19 The Board considered the various views expressed and decided that, as the notion of stability was of primary importance to the function of the control number, the earnings figure would not be an appropriate substitute in the circumstances. It decided to retain the proposals of the FRED for the standard but to emphasise that the permitted method of allocation was allowed only where no other more reliable and accurate method of allocation was available.

Amounts per share reconciliations

- 20 IAS 33, like FRS 3, envisages the disclosure of other amounts per share that may help users evaluate the performance of an entity. Where these are based on a component of profit other than a line item in the profit and loss account, IAS 33 requires a reconciliation to a (non-specific) line item reported in the income statement.
- 21 FRS 3 similarly requires a reconciliation but based on the amounts per share rather than the 'earnings' component and on an itemised basis. It also requires that the reason for the additional figure be disclosed. Respondents showed a clear preference for the clearer and more consistent FRS 3-style reconciliation, which was subsequently approved by the Board.

The 5 per cent materiality threshold

- 22 Under SSAP 3, diluted earnings per share need not be given unless the dilution is material. For this purpose, the standard recognised as material dilution amounting to 5 per cent or more of the basic earnings per share.
- 23 IASC's exposure draft E52 proposed that both basic and diluted earnings per share should be disclosed on the face of the profit and loss account.
- 24 In response to a specific question in the Discussion Paper, there was little support for the withdrawal of the 5 per cent materiality guideline in UK guidance on earnings per share. The Board drew this matter to the attention of IASC. On the basis that diluted earnings per share is a separate performance measure, however, and consistently with its requirement to show trends, IAS 33 retained the requirement to disclose both amounts per share.
- 25 A subsequent question included in the FRED drew more agreement that the 5 per cent limit should be withdrawn because this was consistent with the international requirement. However, a number of respondents argued that, particularly where entities present an alternative measure of performance to basic earnings per share, the diluted figure does not add sufficient value for users to justify a further increase in the volume of financial disclosures.
- 26 The Board was sympathetic to those who expressed concern at the burden of additional disclosures for little purpose but, after careful consideration, it decided that the international requirement to disclose diluted earnings per share should be supported in the FRS.

Computation of earnings per share on the nil basis

- 27 On the basis that this figure may be derived from other disclosures, respondents agreed that there were no circumstances in which earnings per share on the nil basis needed to be disclosed.

Other issues*Restatement*

- 28 Several respondents drew attention to a requirement in IAS 33 that had not featured in the earlier exposure draft—namely, that where there are changes in the number of shares or potential shares in issue arising from certain capital transactions after the balance sheet date but before the issue of the financial statements, their effect must be taken into account in the calculation of basic and diluted earnings per share for the current as well as all previous periods. SSAP 3 had taken the approach that it was desirable for such effects to be disclosed but did not permit them to be taken account of in the current period's computations.
- 29 Respondents argued that the balance sheet provides the only reliable measure of the number of shares outstanding and that application of the international principle would be particularly difficult in the UK because of the interaction with the function and timing of the preliminary announcement. It appeared to the Board that, in practice, there were very few occasions when such transactions were undertaken between the balance sheet date and the issue of the accounts. It decided however that, for clarity, the requirement should be amended in the FRS to 'date of approval' rather than 'date of issue'.

Computation of diluted earnings per share

- 30 A number of respondents were unclear how certain of the general principles of IAS 33 concerning diluted earnings per share were to be applied in practice. Supplementary guidance was requested in respect of contingently issuable shares and employee share schemes in particular, as divergent practices had developed in respect of these issues under SSAP 3. Both matters are addressed in detail by the US FAS 128 in a manner consistent with the requirements of IAS 33. It was suggested, and agreed to by the Board, that further guidance should be included in respect of these two issues based on FAS 128 but tailored to UK circumstances. The Board thought it appropriate to expose the further proposals for comment in a supplement to FRED 16.

Supplement to FRED 16*Contingently issuable shares*

- 31 The basic principle of IAS 33 underlying the treatment of contingently issuable shares for diluted earnings per share purposes is that the end of the reporting period is treated as if it were the end of the contingency period. Some respondents queried this principle and stated their preference for a 'best estimate' of the number of shares that would be issuable in the new period, which they saw as more compatible with the requirements of paragraphs 81 and 82 in FRS 7 'Fair Values in Acquisition Accounting'.

- 32 IAS 33, however, does not permit future projections. Adopting a historical function for diluted earnings per share, it prefers to preserve the consistency between the shares deemed issuable at the end of the period, applying the basic principle described above, and the profits by which they are determined. Hence, IAS 33 requires that diluted earnings per share should be computed to reflect the amount of dilution there would have been had the number of shares deemed issuable at the end of the period been outstanding for the whole of that period.
- 33 The Board acknowledges that there are arguments to support several approaches to determining the number of contingently issuable shares to include in earnings per share calculations—including the ‘best estimate’ approach, the ‘no projection’ approach or one that allows future projections but assumes maintenance of the past performance rate. As IAS 33 had adopted the ‘no projection’ approach and there was no reason to suppose that either of the other methods would necessarily provide a better solution, the Board decided to retain the international requirement, which was also the simplest method of dealing with such contracts for earnings per share purposes. It also noted that this method avoids the potential revision of estimates in future years, with potential effects on the trend of diluted earnings per share.

Employee share schemes

- 34 The proposals were generally accepted as reasonable but further explanation was requested in some areas. Certain of the requirements were redrafted to ease understanding and a worked example (example 5) is included in the FRS for illustrative purposes.

- 35 Several respondents queried the implication of the requirements regarding share schemes in respect of which a charge is made to the profit and loss account in accordance with UITF Abstract 17 'Employee share schemes'. The FRED proposed that additional shares should be included in the denominator of diluted earnings per share but did not propose to permit an adjustment to the numerator in respect of the UITF 17 charge as would seem to be required by paragraphs 11, 37(a) and 38 of FRED 16. Respondents queried why the computation was, in effect, to suffer twice in respect of the dilutive effects of these schemes.
- 36 Paragraphs 11, 37(a) and 38 of FRED 16 referred to costs that would no longer be incurred on conversion of potential ordinary shares. Amounts charged in accordance with UITF 17, however, represent the cost of awarding potential ordinary shares that will still have to be recognised even if the shares are converted. Hence they should not be added back to earnings for the computation of diluted earnings per share. This is consistent with the view of the FASB that a transaction that results in an expense and also increases, actually or potentially, the number of shares outstanding properly affects both the numerator and the denominator of the earnings per share calculation.
- 37 The proposals also included consequential amendments to UITF Abstract 13 'Accounting for ESOP Trusts'. These were necessary to reflect the fact that FRED 16 proposed to abandon a dividend-based criterion for determining which shares to include in the earnings per share calculation as, under IAS 33, they are included from the date consideration is receivable. The Board also took the opportunity in the FRED 16 Supplement to extend the proposed amendments to address the treatment of dividend income receivable by ESOP trusts for the purposes of determining profit before tax generally. Respondents found these proposals largely acceptable.

Special dividends and share consolidations

- 38 In the FRED 16 Supplement the Board also invited views on whether earnings per share should be adjusted for the effects of special dividends—in particular where these are coupled with share consolidations to replicate the effect of a share repurchase. The point at issue was the present anomaly that although the overall effect of the transactions is the same, present guidance would require a restatement of prior periods' earnings per share following the combined transaction, by virtue of the share consolidation element, but would not do so following a share repurchase.
- 39 The supplement put forward three possible options in respect of the problem. The first, option 1, took the view that the anomaly arose because the adjustment did not take account of the second part of the transaction, namely, the special dividend. To put earnings per share on a consistent basis, earnings per share should be adjusted to reflect the very often substantial amounts distributed to shareholders as special dividends and which are not available for future earnings. If a special dividend is viewed as a notional share repurchase followed by a bonus issue, the two component parts could be dealt with in accordance with the general principles of the proposed FRS. Where a combination of a special dividend and share consolidation is designed to achieve the same effect as a share repurchase, the adjustment to prior periods' earnings per share in respect of the notional bonus issue would be exactly offset by the increase arising from the adjustment in respect of the share consolidation. The net result would be no change to prior periods' earnings per share—the same result as if the transactions had been conducted as a straight share repurchase.

- 40 Option 2 was to relax the requirement for prior periods' earnings per share to be adjusted for the effects of a share consolidation that is combined with a special dividend to replicate the commercial effect of a share repurchase. This solution avoided the difficulty of defining a special dividend and distinguishing it from the normal distribution policy.
- 41 Option 3 was to apply the requirements of FRED 16 as it had been published, consistently with the international requirements. On this basis, an adjustment would be required in respect of the share consolidation but not the special dividend. This proposal would see prior periods' earnings per share increased where the combined transactions were undertaken and would not address the anomaly as presented.
- 42 A minority of respondents expressed strong views in respect of options 1 and 3. Option 1 was supported by those who saw it as providing the technical explanation of why it was right that the combined transaction should not generate an adjustment to prior periods' earnings per share. It was thought by many to be complex, however, and to depend on a definition of special dividend that was not sufficiently robust to sustain consistent application.
- 43 Option 3 was supported by a minority who argued that it was better to live with an inconsistency of treatment for earnings per share purposes than to try unsuccessfully to remove it. Several respondents thought it important that option 3 was the only proposal that would be consistent with the international treatment. The point was also made that the occasion of a special dividend itself was sufficient warning that, more so than usual, additional performance measures would need to be referred to in order to evaluate the entity's performance.

- 44 A clear majority of respondents supported option 2. As the combined transaction involves a flow of resources, they thought it inappropriate to restate prior periods' earnings per share in respect of the share consolidation. Although some commentators did not wholly agree with the concept that the payment of a special dividend with a share consolidation has a similar effect to a share repurchase at fair value, they were prepared to support the proposal as a pragmatic solution to the problem.
- 45 The Board considered the various views expressed and concluded that the FRS should apply option 2 as it provided the simplest response to the identified anomaly.
- 46 Some respondents had commented that if option 2 were to be adopted, the Board should extend the relaxation to adjust prior periods' earnings per share to other combined transactions that are designed to replicate the effect of a share repurchase but involve alternative forms of returning capital to shareholders. The Board decided, however, to restrict its discussions to the combination of transactions under review, given the additional time and research that would be required in order to satisfy itself that other types of combinations achieved a similar effect through different routes.

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