TBH Consulting LLC

Earnings Per Share

Executive Summary

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I. Introduction to EPS

Definition of earnings per share

Earnings per share (EPS) is a financial metric required of all public companies to monitor or measure their earnings, performance, and trends over a reporting period.

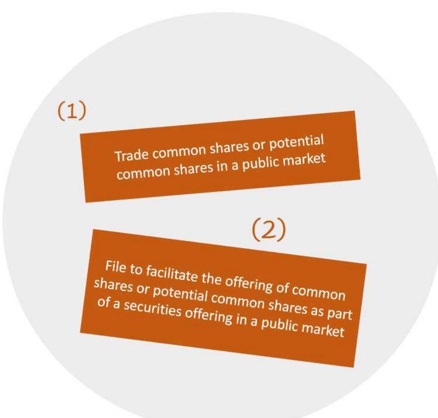
EPS is one metric used by market participants to make investment decisions. Investors may use EPS as one factor in determining corporate value and may be willing to pay more for the entity's shares based on their outlook of the entity's future growth. EPS is valuable to reporting entities when comparing to competitor financial metrics, other companies operating in the same industry, or over a period of time.

Introduction to ASC 260

The guidance in ASC 260 provides presentation and disclosure requirements and governs the computation of EPS and presentation on the financial statements. ASC 260 also applies to interim financial statements, the extent to which depends on whether the interim statements are issued in full, condensed, or summarized.

Scope and exclusions

According to ASC 260-10-15-2, EPS is required to be presented by entities that:



According to ASC 260-10 and 20, a common share is stock that is subordinate to all other stock of the issuer, and a potential common share is a security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period. Options, warrants, convertible securities, contingently issuable shares up until the contingency has been resolved, and unvested share-based payment awards represent potential common shares (which are not included in basic EPS) as they can be exercised and converted to common shares.

Critical issues and factors to consider

Reporting entities should keep in mind that EPS has limitations and does not solely determine the share price. It also does not provide any indication on whether an entity's stock is over or undervalued.

EPS can be calculated using several approaches and it is important to determine how to include various instruments, transactions, and stock-based compensation awards in the calculation. Various types of equity instruments and potential common shares require their own separate analysis so that reporting entities can determine their impact on EPS. EPS calculations can be straightforward or intricate depending on the complexity of capital structures and changes in capital structure due to stock splits/dividends, stock rights plans, distributions, IPO/spin off, partially paid shares and stock subscriptions, bankruptcy, and change of legal form/tax status.

Retrospective adjustments

In circumstances where there is a change in capital structure resulting in a change in the number of common shares outstanding while resources or capital base remains constant, EPS is adjusted for comparative periods retrospectively. Retrospective adjustments include:

1) Stock dividends, splits, and reverse stock splits: The EPS denominator is adjusted to reflect the weighted-average shares outstanding following the event.
2) Rights Issues: The EPS denominator is adjusted for the bonus element (of rights issues whose exercise price at issuance is less than the fair value of the stock) for all periods presented based on a formula.
3) Reverse acquisitions, business combinations, and reorganizations: The EPS numerator and/or denominator are adjusted. In business combinations, the numerator is not adjusted and the denominator is only adjusted prospectively if shares are issued in the transaction.
4) Retrospectively applied accounting changes and error corrections: The EPS numerator (and denominator if necessary) is adjusted, as necessary, to reflect the accounting change or error correction.

ASC 260 requires Basic and diluted EPS to be retrospectively adjusted for such events during the reporting period occurred and for all prior periods presented in order to reflect a reporting entity's earnings and to strengthen comparability over time.

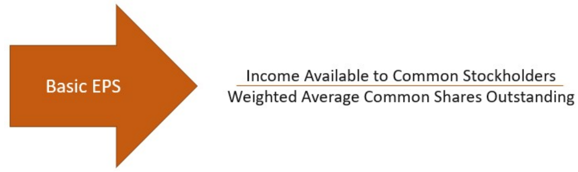
II. Basic EPS

The reporting of both basic and diluted EPS is required for each reporting period for public companies. ASC 260-10-20 defines basic earnings per share as:

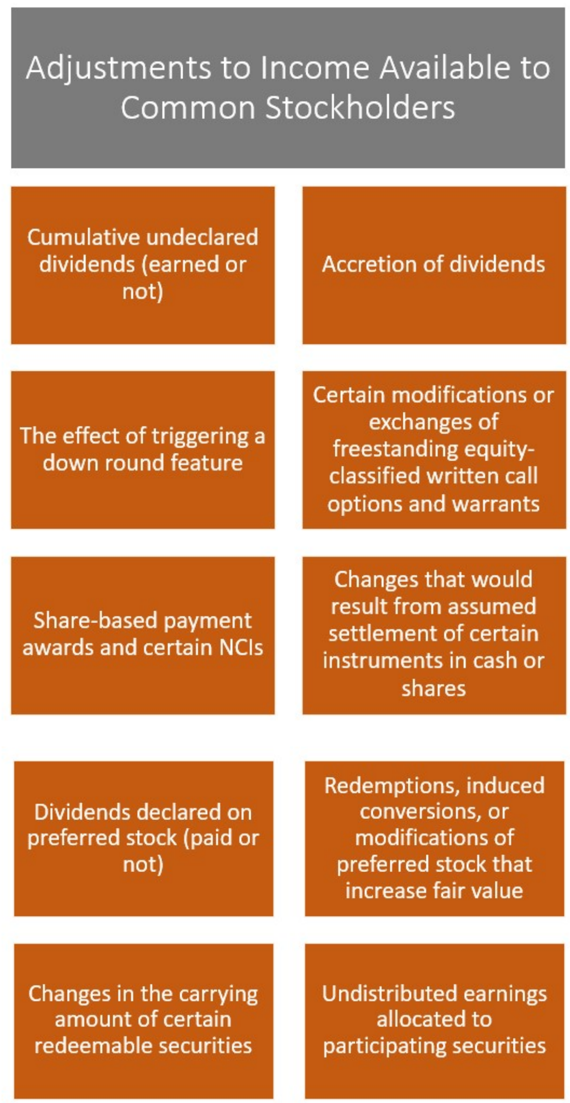
> The amount of earnings for the period available to each share of common stock outstanding during the reporting period.

Calculating basic EPS

Basic EPS is computed as income available to common stockholders divided by the number of weighted average common shares outstanding during the period.



Reporting entities are required to determine which earnings to use when computing the numerator.



Dividends declared on preferred stock and dividends accumulated on cumulative preferred stock should be deducted from Income from Continuing Operations and Net Income (or added to any loss or net loss), according to ASC 260-10-45-11 to arrive at Net Income Available to Common Stockholders. If earned, those that are cumulative should be deducted to the extent of earnings. Adjustments must be made to income/loss for returns on other classes of equity instruments, such as preferred shares and participating securities, that have not been previously deducted. Income from Continuing Operations and Net Income should also be adjusted for cumulative undeclared dividends, accretion/decretion of equity, redemption, induced conversion, or certain modifications of preferred stock, and certain modifications/exchanges of equity classified warrants.

Weighted average number of shares outstanding (WASO)

The identification of common shares and when they are outstanding is necessary to determine the denominator. According to ASC 260-10-45-10, shares issued and shares reacquired during the period shall be weighted for the portion of the period that they were outstanding. The period outstanding begins on the date which the corresponding consideration is received. The terms and conditions of any contract associated with the issuance of common shares dictates the precise timing of the inclusion of common shares as being outstanding, according to ASC 505-10-45-2.

ASC 260-10-55-2 governs the computation for determining the number of weighted average shares outstanding. The "weighted average" is a mean average. The most precise average would be the sum of the shares determined daily divided by the number of days in the period, but it is not required. Less-precise averaging methods may be used, if reasonable. The ASC 260 glossary recalls that the weighted average is used so that the effect of any increase or decrease in the number of common shares on the EPS calculation is related only to the portion of the period during which the related resources are available for use in the entity's operations.

Outstanding common shares in the basic EPS calculation include the issuance of additional common shares contingent upon certain conditions being met only if all the necessary conditions for the issuance have been satisfied by the end of the period, according to ASC 260-10-45-12A. Other items excluded from WASO include mandatorily convertible instruments, prepaid variable share forward sale contracts, restricted stock-based compensation awards, employee stock options, mandatorily redeemable common stock, forward purchase contracts for a fixed number of shares, share lending arrangements, and employee stock purchase plans.

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The number of shares outstanding fluctuates over time and so the weighted average is used to incorporate any changes over the reporting period.

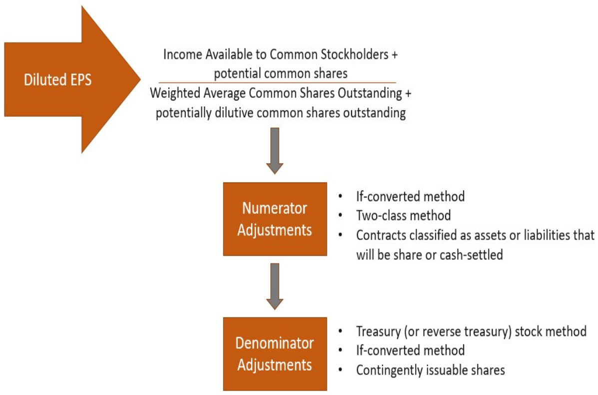
III. Diluted EPS

ASC 260-10-20 defines diluted earnings per share as

The amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period.

Calculating diluted EPS

Diluted EPS is computed by income available to common stockholders, adjusted for the issuance of potential common shares, divided by the number of weighted average common shares outstanding plus potentially dilutive common shares outstanding during the period.



Both numerator and denominator of basic EPS are adjusted to account for the income and weighted average amount of shares that would have existed if the potential common shares were actual common shares during the period they were outstanding. Only dilutive securities are included in the diluted EPS computation; therefore, antidilutive potential common shares are not included.

Dilutive: the effect of certain actions or activities that reduce EPS

Antidilutive: activities that maintain or increase EPS

According to ASC 260-10-55-32, the income or loss adjustments in the diluted EPS calculation resulting from the assumed issuance of potential common shares should include the fair value adjustments on liability instruments which can be settled in shares.

Dilutive instruments that are:

1) Issued

2) Expire unexercised

3) Cancelled during the period

4) Exercised during the period prior to exercise

should be included in the diluted EPS denominator for the portion of the period they were outstanding. Actual shares issued should also be included in both the basic and diluted EPS denominator.

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Diluted EPS is basic EPS adjusted for the assumed issuance, conversion, or exercise of potentially dilutive securities.

In determining whether potential shares are dilutive or antidilutive, the control number concept is often used. According to ASC 260-10-45-20, income/loss from continuing operations, adjusted for preferred dividends, represents the control number or benchmark used to determine whether the potential common shares are dilutive or antidilutive. Reporting entities with discontinued operations are required to use this control number. The number of potentially dilutive securities applied in diluted EPS from continuing operations must also be applied to all other income or loss categories, despite possibly having an anti-dilutive effect. Each issue or series of issues of potential common shares should be considered separately and not in aggregate. They should also be applied in sequential order from the most to least dilutive to reflect the maximum potential dilution.

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The dilutive potential common shares with higher earnings per incremental share (least dilutive) are included in diluted EPS following those with lower earnings per incremental share (most dilutive).

This method is ultimately used to determine if the result is dilutive to basic EPS.

Diluted EPS methods

Reporting entities can choose from two methodologies when calculating diluted EPS. The method selected should be appropriate to the type of financial instrument.

The Treasury Stock Method applies to options and warrants (issued, exercised, or expired), forward contracts, unit structures, restricted stock, and employee stock purchase plans. According to ASC 260-10-20, the Treasury Stock Method is a method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds from exercise would be used by the reporting entity to repurchase common stock at the average market price during the period. In applying the Treasury Stock Method, any nonrecourse loan amount issued by the option holder to the reporting entity to be exercised should be considered as exercise proceeds and treated as if the option remains outstanding. If a recourse note is issued to exercise the option, an additional analysis to determine the substance of the arrangement should be performed.

According to ASC 260-10-20, the If-Converted Method is a method of computing EPS data that assumes conversion of convertible securities (including convertible debt and convertible preferred stock) to common stock of the reporting entity as potential common shares at the beginning of the reporting period (or at time of issuance, if later) and the resulting common shares are included in the diluted EPS denominator for the entire period presented. It is the method primarily used to calculate the dilutive effect of convertible debt and convertible preferred stock. Per ASC 260-10-45-40 through 42, the If-Converted Method is used to include share-settled convertible debt and convertible preferred stock in diluted EPS.

The If-Converted computation adds back interest (which includes the effect of accretion of discounts or amortization of premiums and debt issuance costs) net of tax and dividends on convertible securities to the diluted EPS numerator. The after-tax effects of income-based nondiscretionary adjustments that would have had a different calculation, if interest or dividends were not recognized, are also added back to the numerator.

Contingently issuable shares that would be issued as of the end of the reporting period (equating to end of the contingency period) are also included in the diluted EPS denominator for the entire period as part of the diluted EPS calculation. Awards such as performance-based stock options are considered contingently issuable for purposes of determining diluted EPS. This does not include awards subject to only service vesting. In summary, the contingently issuable shares should be included in diluted EPS if they are dilutive and if the specified condition is met for issuance as of the end of the reporting period. Any further dilution arising from the achievement of higher earnings and additional shares becoming issuable is not included in the diluted EPS calculation.

The diluted EPS numerator may also need to be adjusted for any income/loss changes resulting from the assumed settlement of instruments in cash or shares according to contract. After the adoption of ASU 2020-06, the ASC 260 amendments require the effect (if more dilutive) of potential share settlement for these instruments (excluding share-based payment awards classified as liabilities) to be included in the numerator.

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The effect of potential share settlement must be included in diluted EPS regardless of history, policy, or whether the holder was given a choice between cash and share settlement.

IV. Two-Class Method

Participating securities

Securities that have the right to participate in undistributed earnings with common stock are considered participating securities according to ASC 260-10-20. Participating equity securities can be those that partake in dividends with common shares or a class of common stock with different dividend rates from those of another but without priority or senior rights.

Potential common shares (securities or other contracts that may entitle their holders to obtain common stock such as options, warrants, forwards, mandatorily redeemable stock, or other contracts) may be participating securities if, in their current form, they are entitled to receive dividends when declared on common stock, according to ASC 260-10-45-60A.

Applying the two-class method

ASC 260-10-45-60 describes the two-class method as an earnings allocation formula that treats a participating security as having rights to earnings that otherwise would have been available to common shareholders. Reporting entities that have a multilayered capital structure with various types of participating securities are required to determine Income Available to Common Shareholders by using the two-class method. Multilayered capital structures may contain financial instruments such as participating equity securities and common shares without priority or senior rights and with a different dividend rate from that of another class of common shares.

The two-class method allocates earnings to security holders as EPS is computed for each class of common stock and participating security. The computation considers all earnings, even declared or accumulated dividends and participation rights in undistributed earnings which are treated as if they had been distributed during the period.

The identification of any participating securities that are entitled to the rights to receive dividends declared on common stock (prior to exercise, settlement, conversion, or vesting), as if all undistributed earnings for the period were distributed, is key to applying the two-class method.

According to ASC 260-10-45-17 through 20, reporting entities should not assume exercise or conversion for the participating securities. Therefore, the denominator in the EPS calculation remains unchanged by the participating security while the numerator is reduced for both basic and diluted EPS, resulting in a reduced EPS.

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Participating securities reduce EPS regardless of whether dividends are actually paid since earnings are allocated away from common stockholders to participating security holders.

Under the two-class method, basic and diluted EPS for participating securities are not required to be presented, unless it is a second class of common stock. Two classes of common stock can be combined and presented as one for EPS purposes if both classes have identical rights and privileges, except for voting rights, where the classes otherwise have an equal share in dividends and residual net assets. The facts and circumstances surrounding the earnings per share amounts, which reflect both classes of common stock, should be disclosed in the financial statement footnotes.

Undistributed earnings for the period must be allocated to a participating security based on its contractual participation rights to share in the earnings as if they all had been distributed. According to ASC 260-10-45-67 and 68, losses of the reporting entity should only be allocated to convertible and nonconvertible participating securities if they have an obligation to share in the losses based on the participating securities' contract terms and the shared loss basis is objectively determinable.

V. Presentation and Disclosure

Presentation

Per ASC 260-10-45-2, basic EPS is required to be presented on the Income Statement for Net Income and Income from Continuing Operations, if applicable, for each class of common stock for all periods for which an Income Statement is presented. Diluted EPS is required to be presented in the same manner and with equal prominence as basic EPS on the face of the Income Statement for entities with outstanding potential common stock. If both EPS amounts are equal for all periods, their presentation can be combined as one line item.

Basic and diluted EPS must also be presented for discontinued operations according to ASC 260-10-45-3 either on the face of the Income Statement or in the notes as elected by the reporting entity. If electing to present a single statement of comprehensive income, entities can present EPS after Net Income and before Other Comprehensive Income. EPS presentation is not required or prohibited for a participating security other than common stock.

Per ASC 220-10-S99-5 (SAB Topic 6.B), the SEC requires Income/Loss Available to Common Stockholders that is materially different from Net Income/Loss to be presented on the Income Statement.

> According to ASC 260-10-45-4, "basic EPS" and "diluted EPS" are not required Income Statement line item titles and there are many acceptable titles that reporting entities can use.

Disclosure requirements

For each period for which an income statement is presented, ASC 260-10-50-1 requires reporting entities to make the following disclosures:

1. A reconciliation of the numerator and denominator for Income from Continuing Operations (for both basic and diluted EPS) that includes individual income and share amount effects of all securities that impact the EPS calculation
2. The basic EPS effect of preferred dividends on Income Available to Common Stockholders
3. Key terms and conditions of anti-dilutive securities excluded from diluted EPS for the period(s) presented that have a potentially dilutive impact on basic EPS in the future
4. Impairment measurement, allocation, presentation, and disclosure

A description of subsequent events occurring after the end of the most recent balance sheet that have a material impact on the number of common shares or potential common shares outstanding should be disclosed before financial statement issuance. Retroactive adjustments are needed for basic and diluted EPS calculations for all periods presented if stock dividends or splits cause changes in common stock after period close but before financial statement issuance. If the EPS calculations reflect changes in capital structure, the fact must be disclosed.

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Some SEC filings require pro forma EPS to be disclosed for certain events and circumstances including subsequent events and capital structure changes that affect the EPS computation.

The disclosure of participation rights on outstanding securities is required by ASC 505-10-50-3 and the relevant rights and privileges of each outstanding instrument should be explained, according to ASC 505-10-50-13. Non-GAAP EPS measures that comply with SEC Regulation S-K, Item 10(a) are permitted to be disclosed in the annual filing as long as they are significant, not emphasized, and are aligned with GAAP EPS. The EPS impact of restructurings, charges subject to ASC 420 guidance, impairments, exit or disposal cost obligations, etc. may be disclosed in the footnotes.

ABOUT US

TBH Consulting provides accounting and financial reporting services. We deliver Big 4 level of experience to our clients at competitive rates. We can mobilize the right resources at the right time to meet our clients' needs, whether such clients are Fortune 500, middle-market public companies or pre-IPO companies.

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