

P R I S T I N E

Financial Reporting and Analysis - II

Diluted EPS

- Diluted EPS is lower than Basic EPS
- Diluted EPS is calculated when capital structure contains dilutive securities like stock options, warrants, convertible debt, or convertible preferred stock
 - These securities will decrease EPS if exercised / converted to common Stock
- However these securities could be anti-dilutive as well if these would increase EPS when they are exercised or converted to common stock
 - Anti dilutive securities are not considered in the calculation of diluted EPS

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Sample Material

** Important concept*

Diluted EPS – Adjustments for convertible securities

- For Convertible preferred shares
 - Dividends must be added to earnings available to common shareholders
- For Convertible Bonds
 - Bonds' after-tax interest expense is not considered an interest expense for diluted EPS and added earnings available to common shareholders
- For Both
 - Number of weighted average share are increased by new common shares that would have been issued at conversion of convertible preferred shares / convertible bonds

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Diluted EPS – Adjustments for stock options

- For stock options / warrants, Treasury Stock Method is used to calculate Diluted EPS
 - The treasury stock method assumes that the hypothetical funds received by the company from the exercise of the options would be used to purchase shares of the company's common stock in the market at the average market price
- Hence while calculating diluted EPS for Stock options or warrants
 - There is **no adjustment to earnings** available to common shareholders
 - Weighted average share are
 - **Increased** by No. of shares that would have been issued on conversion of stock options / warrants
 - **Decreased** by no of shares that would have been purchased by hypothecated cash receipt using treasury stock method

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** Important concept*

Diluted EPS – Stock options adjustment

- Each potentially dilutive security **must be examined separately** to determine if it is actually dilutive
- Stock options and warrants are dilutive only when their
 - Exercise prices < Average market price of the stock over the year

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To sum up - Diluted EPS equation is

- Numerator
 - [(net income – preferred dividends) + (convertible preferred dividends) + (convertible debt interest) * (1-tax)]
- Denominator
 - (Weighted average shares + Shares on conversion of conv. Pref. shares + shares from conversion of debt + Shares issuable from stock options / warrants)

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