

1 ☐ Part 1: Dilutive Securities &  
Part 2: Earnings Per Share

**Chapter 17**

A dilutive or potential common stock is a convertible security or stock option which dilutes/reduces the EPS when converted or when option to purchase is exercised

2 ☐ Accounting for Convertible Debt

- Bonds which can be converted into common stock during some specified period after issuance
- Major advantages to issuing firm:
  - relatively low loss of ownership control
  - obtain common stock financing at lower interest rate
- Major reporting issues:
  - accounting at time of **issuance**
  - accounting at time of **conversion**
  - accounting at time of **retirement**

3 ☐ Reporting Issues -- At Issuance

- entries similar to regular issue of bonds
  - Dr. Cash (proceeds less bond issue cost)
  - Dr. Bond Issue Cost
  - Dr. Discount on Bonds Payable
  - Cr. Bonds Payable (face value of bond)
  - Cr. Premium on Bonds Payable
- amortize premium or discount using effective interest method (or straight-line if difference is not material)

4 ☐ Reporting Issues--At Conversion

- Market Value Approach
  - use mkt value of stocks or bonds
  - report loss or gain as ordinary
- Accounting Entries
  - Dr Bonds Payable (principal amount of bonds)
  - Dr Premium on B/P (unamortized premium)
  - Dr Loss on Redemption (mkt. val. - bk val.)
  - Cr Common Stock (par value of stock)
  - Cr PIC in Excess of Par (mkt val - par value)
  - Dr Discount on B/P (unamortized discount)
  - Cr Gain on Redemption (bk val -- mkt val.)

5 ☐ Reporting Issues - At Conversion

- Book Value Method
  - most common method in practice; no gain/loss
  - book value of bonds used as basis for transaction
- Accounting Entries
  - Dr Bonds Payable (principal amount)
  - Dr Debt Conversion Expense (cost to induce conversion)
  - Dr Premium on B/P (unamortized premium)
  - Cr Common Stock (par value of stock)
  - Cr PIC in Excess of Par (BV of bonds - par of stock)

- Cr Discount of N/P (unamortized discount)
- Cr Cash or Common Stock (money/stock paid to induce conversion)

## 6 ☐ Reporting Issues - At Retirement

- **Arises if bonds are not converted before maturity -- treat as regular bond retirement/extinguishment**
- **Cash acquisition price of debt minus carrying value record as extraordinary gain or loss**
- **Accounting Entries:**
  - Dr Bonds Payable (face value of bonds)
  - Dr Prem.on B/P or Cr Discount(unamortized)
  - Dr Extraordinary Loss or Cr Extraordinary Gain
  - Cr Cash

## 7 ☐ Convertible Preferred Stocks

- **Represent preferred stocks that can be converted to common stocks**
- **At Issuace -- same as other stocks**
- **At conversion -- use book value method**
- **Accounting Entries:**
  - Dr Preferred Stock (par value)
  - Dr PIC of Preferred Stock
  - Dr Retained Earnings (if par value of CS> book value of Preferred Stock)\* \*not allowed in certain states, have to use PIC
  - Cr Common Stock
  - Cr PIC of Common Stock

## 8 ☐ Stock Warrants

- **certificates that entitle holder to buy common stock at a stated price during a specified period**
- **Stock warrants issued with other securities (say, preferred stocks or bonds) may be detachable or nondetachable**
- **If detachable use (APB Opinion No 14):**
  - proportional method (fair value of bonds and warrant are known)
  - incremental method (fair value of either bond or warrants not known)

## 9 ☐ Stock Rights

- **right given to existing shareholders to be the first to purchase new issues of common stock**
- **At issuance -- no entry**
- **When rights are exercised:**
  - dr Cash; cr CStock (if cash = par value)
  - dr Cash; cr CStock; cr PIC (if cash > par value)
  - dr Cash; dr PIC; cr Cstock (if cash < par value)

## 10 ☐ Stock Options (1 of 2)

- **used as a form of compensation to give selected employees option oto purchase Cstock at a given price ove a specified period**
- **Terminology**
  - grant date: date employees receive the options
  - measurement date: date when # of shares & option price of shares are known
  - service period: period in which employee performs service to earn option

## 11 ☐ Stock Options (2 of 2)

- **2 Methods:**

- Intrinsic Value Method (APB Opinion No 25) -- compensation cost is the difference between the market price of the stock and the option price
- Fair Value Method (SFAC No 123) -- encouraged but not required -- compensation cost is based on the fair value of the option using pricing models such as Black-Scholes

- **Major accounting issues:**

- how should compensation expense be determined?
- over what period should the expense be allocated?

12 ☐ **Computing Earnings Per Share**

- **EPS -- indicates the income earned by each share of common stock**
- **SFAS No 128 requires corporations to report EPS on the face of the income statement below net income**
- **EPS should be disclosed for each component of net income: income from continuing operations; income before extraordinary item; net income**

13 ☐ **EPS & Capital Structure**

- **Calculation of EPS dependent on capital structure -- simple or complex**
- **Simple -- consist only of common stock or includes no potential common stock**
  - Basic EPS -- Net Income Available to Common Stockholders divided by Weighted Avg. Cstock
- **Complex -- capital structure that includes convertible securities**
  - Primary EPS & Fully Diluted EPS needed

14 ☐ **Weighted Avg. Number of Shares Outstanding**

- **shares issued or purchased must be weighted by the fraction of the year they are outstanding**
- **goal is to determine the equivalent number of whole shares outstanding for the year**
- **stock dividends/splits always assumed to have occurred at beginning of the year**

15 ☐ **Diluted EPS (1 of 2)**

- **Dilution due to convertible securities**
  - use "if-converted Method"
  - adjust numerator with any interest that would be saved if bonds were converted or with any dividend not paid if preferred stock converted
  - adjust denominator with any additional shares resulting from the conversion of the bonds or preferred stocks
  - EXCLUDE any anti-dilutive securities

16 ☐ **Diluted EPS (2 of 2)**

- **Dilution due to options and warrants**
  - use "treasury stock method"
  - pretend options are exercised, cash received from shares at option price and stocks issued
  - pretend cash is used to repurchase at market price the stocks issued above
  - if stocks issued are greater than stocks repurchased then potential incremental increase in stock exist -- dilutive and should be added to denominator of EPS formula (if not -- then antidilutive and not used)