

Hong Kong GAAP Update

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Revision of Earnings Per Share Standard

THE Hong Kong Society of Accountants (HKSA) has recently issued a revised version of Statement of Standard Accounting Practice No. 5 (SSAP 5) entitled Earnings Per Share. The revised standard is effective for accounting periods beginning on or after 1 January 1998. The lead time for implementation of the revised standard is therefore very short, since it will be effective for June 1998 interim reporting.

Executive Summary

The objective of the revision is to bring Hong Kong practice into line with the equivalent International Accounting Standard, IAS 33, which will also be effective for December 1998 year ends.

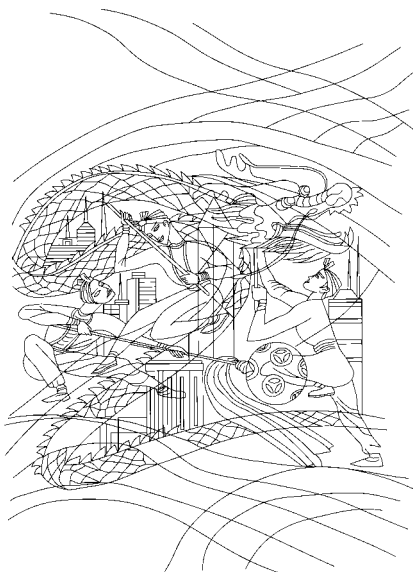
The principles underlying SSAP 5 have not changed - the standard is aimed at listed companies and requires the calculation of a basic earnings per share figure and, where appropriate, diluted earnings per share.

The principal effects of the revisions will be:

- the earnings figure to be used in the calculation will be after deduction of extraordinary items;
- the detailed rules for calculation of diluted earnings per share will give a different result in many circumstances; and
- earnings per share calculations will need to be adjusted for post year-end bonus issue and similar changes in the number of shares without a corresponding change in resources.
- A detailed analysis of the revised standard, and a comparison with previous practice, are set out in Appendix I to this Update.

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Overview

The principles underlying SSAP 5 have not been altered by the revision of the standard - differences arise mainly in the detailed number-crunching. However, it is important to become familiar with the detailed rules, and to 'read the small print' because many of the most familiar concepts have been altered.

The language of the revised standard is very different, and more difficult, than that of its predecessor. This is most obvious with the introduction of the concept of a "potential ordinary share" i.e. a financial instrument or other contract that may entitle its holder to ordinary shares. In practice, this will generally equate to the instruments we are accustomed to dealing with under SSAP 5 (i.e. convertible debt, convertible preference shares, options and warrants) - but the looser definition may extend the application to more innovative financial instruments.

Basic earnings per share

As outlined in Appendix I, for the purposes of basic earnings per share, the impact of the SSAP 5 revisions is that:

- extraordinary items should now be deducted in arriving at an earnings figure; and
- **all** ordinary shares in issue during the period must be included in the denominator. Previously, shares which did not rank for dividend in the current period were excluded.

Diluted earnings per share

The most significant effect of the revised standard in practice will be the impact on the calculation of diluted earnings per share. The detailed rules are more complex than in the original standard and, because they are based on the concept of diluted earnings per share as a measure of past performance rather than as a predictor of future earnings per share, will often result in a different answer.

The principal differences which arise in the calculation of diluted earning per share are as follows:

- rather than imputing a notional return on assumed proceeds from the exercise of options and similar instruments, the assumed proceeds are considered to have been received from an issue of shares at fair value. Fair value is defined as the amount for which the share could be exchanged in an arm's length transaction and is calculated on the basis of the average share price during the period. The difference between the number of shares to be issued under the share purchase arrangement and the number of shares that would have been issued at fair value is treated as an issue of ordinary shares for nil consideration and added to the ordinary shares in issue in the computation of diluted earnings per share.

This treatment is based on a view of options and similar commitments to issue shares at less than fair value as consisting of two elements - a commitment to issue a certain number of shares at fair value (which has no effect on diluted earnings per share) and a commitment to issue the remaining shares for no consideration (which is added to the number of ordinary shares for the purposes of diluted earnings per share calculations);

- all dilutive potential ordinary shares in issue during the period are taken into account, not just those which are in issue at the year end. Where potential ordinary shares have been in issue during the period, but have been cancelled or lapsed during the period, they are included in the computation of diluted earnings per share for the portion of the period for which they were outstanding. Potential ordinary shares that have been converted into ordinary shares during the 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 basic earnings per share;
- the test as to whether or not a potential ordinary share is considered to be dilutive has been modified. Previously, the dilution effect was judged by the impact on basic earnings per share. Under the revised standard, the 'control' number is the net profit per share from continuing ordinary operations, and any instrument which increases that number is considered to be anti-dilutive. In addition, the effect of each issue or series of potential ordinary shares is considered separately (and in a specified sequence) rather than in aggregate;
- the exemption stated explicitly in the original SSAP 5 (no requirement to present diluted earnings per share where the basic figure is a loss per share) is not repeated in the revised standard;
- the exemption stated explicitly in the original SSAP 5 (no requirement to present diluted earnings per share if dilution is immaterial) is not available under the revised standard. This is due to an increased emphasis on showing trends of diluted earnings per share;
- the potential ordinary shares to be taken into account include instruments of subsidiaries, joint ventures or associates (whether convertible into ordinary shares of the subsidiary, joint venture or the associate, or the reporting enterprise) where they would have a dilutive effect on the consolidated basic earnings per share of the reporting enterprise; and
- comparatives are not restated for changes in the assumptions used or for the conversion of potential ordinary shares outstanding.

The exemption stated explicitly in the original SSAP 5, that diluted earnings per share need not be presented if dilution is immaterial, is not available under the revised standard.

Effect of share issues with a 'bonus' element

SSAP 5 has always required that the bonus element inherent in events such as a rights issue made at less than market price be recognised by adjusting the number of shares for all periods prior to the rights issue by the factor:

$$\frac{\text{Actual CUM-RIGHTS PRICE}}{\text{Theoretical EX-RIGHTS price}}$$

The revised standard retains this principle, but the factor is expressed slightly differently as:

$$\frac{\text{FAIR VALUE immediately prior to exercise}}{\text{Theoretical EX-RIGHTS fair value}}$$

Fair value is defined as the amount for which the share could be exchange in an arm's length transaction. In theory, market price will reflect the fair value, but the revised formula allows that the quoted price on a particular day may be distorted and may not reflect the price that could realistically be achieved. Fair value is thus considered to be a more neutral measure.

Changes in the number of ordinary shares or potential ordinary shares outstanding without a corresponding change in resources which occur after the balance sheet date must be taken into account in calculating earnings per share for the period.

Post year-end changes

Under the revised SSAP 5, changes in the number of ordinary shares or potential ordinary shares outstanding without a corresponding change in resources (e.g. capitalisation/bonus issue, bonus element of rights issue, share split or consolidation of shares) which occur **after the balance sheet date** must be taken into account in calculating both basic and diluted earnings per share.

For all such issues, this requires that the calculation of basic and diluted earnings per share for all periods presented should be adjusted retrospectively.

Points to note in this regard are:

- these provisions include the bonus element of issues such as rights issues. Therefore, a post year-end rights issue at less than market price will affect the earnings per share for all periods presented;
- only changes which occur before the issue of the financial statements will give rise to adjustments. Therefore, bonus issues etc. which are proposed for approval at the annual general meeting will have no impact; and
- the revised standard encourages disclosure of other ordinary share transactions or potential ordinary share transactions which 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 (general SSAP 9 criteria are applied). However, no adjustment to reported

figures is made.

Comparison with International Accounting Practice

SSAP 5 is consistent with the equivalent International Accounting Standard (IAS 33) in all respects. Amendments made have been restricted to terminology differences arising in a Hong Kong context.

FASB 128 (Earnings Per Share) issued in the US in February 1997 adopts a consistent approach to the calculation and disclosure of earnings per share.

In the UK, a current exposure draft proposes a similar model. A final standard is expected this year.

~~Where historical summaries of financial information are provided, these should be adjusted to reflect the accounting practices in the revised standard.~~

Transitional Provisions

The revised standard is effective for accounting periods beginning on or after 1 January 1998. Earlier adoption is encouraged, but not required. Where the revisions have been adopted in advance of their mandatory application date, that fact should be disclosed.

Corresponding amounts should be restated. In particular, where historical summaries of financial information are provided, these should be adjusted to reflect the accounting practices in the revised standard.

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Topic	SSAP 5 (Revised)	Comparison with existing practice
Scope of Standard	<p>Applies to enterprises whose ordinary shares or potential ordinary shares are publicly traded or that are in the process of issuing shares or potential ordinary shares to the public.</p> <p>Other enterprises which choose to present earnings per share information should also comply with the Standard.</p>	<p>The previous standard applied only to companies having a listing on the Stock Exchange of Hong Kong Limited for any class of equity.</p> <p>The inclusion of ‘potential ordinary shares’ which are listed will bring within the scope of the standard any enterprises whose ordinary shares are not listed but having outstanding publicly traded warrants, bonds etc which are convertible into ordinary shares.</p>
“Earnings” for the purposes of basic earnings per share	<p>After deduction of:</p> <ul style="list-style-type: none"> • all expenses including tax, extraordinary items and minority interests; and • preference dividends (including cumulative dividends that have not been declared). 	<p>Previously, the earnings figure used was before taking account of extraordinary items. However, given the rarity of extraordinary items following the 1993 amendment to SSAP 2, this difference is unlikely to have a significant effect in practice.</p>
Number of shares for the purposes of basic earning per share	<p>The weighted average number of ordinary shares outstanding in the period - adjusting the shares at the beginning of the period by the number of shares bought back or issued during the period, multiplied by a time-weighting factor.</p> <p>The weighting factor is determined by reference to the date of issue or date of buy-back of shares. The revised standard includes extensive guidance on appropriate recognition dates for shares issued in various circumstances.</p>	<p>Previously, shares which did not rank for dividend in the current period were excluded from the denominator for basic earnings per share calculations. The revised formula includes all ordinary shares in issue - including shares with deferred dividend rights.</p> <p>The detailed guidance on recognition dates does not differ significantly from previous best practice, but the new standard will result in a formalisation of the rules.</p>

Topic	SSAP 5 (Revised)	Comparison with existing practice
<p>Diluted earnings per share</p>	<p>Presentation of diluted earnings per share is required for any accounting periods during which dilutive potential ordinary shares (i.e. financial instruments/ contracts entitling their holders to ordinary shares which, on conversion to ordinary shares, would decrease earnings per share from continuing ordinary operations) are in issue.</p> <p>This requirement applies equally to potential ordinary shares of subsidiaries, joint ventures or associates (whether convertible into ordinary shares of the subsidiary, joint venture or the associate, or the reporting enterprise) where they would have a dilutive effect on the consolidated basic earnings per share of the reporting enterprise.</p> <p>The effects of 'anti-dilutive' potential ordinary shares (i.e. those whose conversion would increase earnings per share from continuing ordinary operations) are ignored in calculating diluted earnings per share.</p>	<p>The general circumstances where presentation of a diluted earnings per share figure is required will not change - although the wider definition of 'potential ordinary share' extends the application to more innovative financial instruments.</p> <p>Under the previous standard, only financial instruments which could be converted into equity shares of the reporting entity (whether issued by the reporting entity or any of its subsidiaries) were considered.</p> <p>Previously the control number for determining whether or not a share was dilutive was the basic earnings per share.</p>
<p>Diluted earnings per share (cont'd)</p>	<p>In considering whether potential ordinary shares are dilutive or anti-dilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which they are considered, which may affect is outcome, is specified as being from the most dilutive to the least dilutive, in order to maximise the dilution of basic earnings per share.</p> <p>Where potential ordinary shares have been in issue during the period, but have been cancelled or have lapsed during the period, they are included in the computation of diluted earnings per share for the portion of the period during which they were outstanding.</p> <p>No restatement is made of diluted earnings per share of any prior period for changes in the assumptions used or for the conversion of potential ordinary shares into ordinary shares outstanding.</p>	<p>In the absence of specific guidance, the original standard was taken to mean that the effect of all outstanding instruments would be considered in aggregate.</p> <p>Under the previous standard, only instruments outstanding at the end of the period were considered.</p> <p>Previously, presentation of comparative diluted earnings per share was not required unless the assumptions on which it was based continued to apply. If the instrument was exercised or lapsed during the period, no comparative would be presented.</p> <p>Specific exemptions provided for in the previous standard (e.g. on the basis of materiality or because the basic figure was a loss per share) are not repeated.</p>

Topic	SSAP 5 (Revised)	Comparison with existing practice
<p>“Earnings” for the purposes of diluted earnings per share</p>	<p>Earnings for the purposes of basic earnings per share to be adjusted for the after-tax effects of:</p> <ul style="list-style-type: none"> • dividends and interest charged in relation to dilutive potential ordinary shares; and • any other changes in income that would result from the conversion of the potential ordinary shares. 	<p>Similar principle.</p> <p>Under the existing standard, earnings were adjusted for the assumed investment of proceeds from the exercise of the options/warrants. This adjustment will no longer be made - the effect of options and warrants is dealt with by adjusting the number of shares, as discussed below.</p>
<p>Number of shares, for the purposes of diluted earnings per share</p>	<p>Number of ordinary shares to be adjusted for the number of shares that would be issued on the conversion of all of the dilutive potential ordinary shares. Shares should be deemed to have been converted on the first date of the accounting period or the date of issue, if later.</p> <p>The assumed proceeds from conversion should be considered to have been received from an issue of shares at fair value. The difference between the number of shares issued and the number that would have been issued at fair value should be treated as an issue of ordinary shares for no consideration (see example in Appendix II).</p>	<p>This represents a significant change from previous requirements, when the number of ordinary shares was adjusted for the actual number that would be issued on exercise of the conversion or option rights.</p>
<p>Adjustment for the entire period and of comparatives</p>	<p>The weighted average number of shares outstanding during the period and for all periods presented should be adjusted for events which change the number of ordinary shares outstanding without a corresponding change in resources eg:</p> <ul style="list-style-type: none"> • capitalisation/bonus issue; • bonus element of any other issue; • share split; and • consolidation of shares. <p>If these changes occur after the balance sheet date, the calculation of earnings per share should be based on the new number of shares, and the fact that such adjustments have been made should be disclosed.</p> <p>In addition, adjust all periods presented for:</p> <ul style="list-style-type: none"> • prior period adjustments; and • business combinations accounted for as a uniting of interests. 	<p>Revised SSAP is consistent with previous SSAP as regards changes during the reporting period.</p> <p>Under the previous standard, no adjustment was made for post-year end changes. It was considered desirable to disclose the effect of a post year end change, but this was not required.</p> <p>Although not specified, this would have been the usual practice.</p>

Topic	SSAP 5 (Revised)	Comparison with existing practice
Presentation	<p>Present basic and diluted earnings (or loss) per share on the face of the profit and loss account, with equal prominence.</p> <p>Separate figures should be presented for each class of ordinary shares that has a different right to share in the net profit for the period.</p>	<p>No significant change except that, under the previous standard, the fully diluted earning per share would not be shown when the basic earnings per share was a negative figure.</p>
Disclosure	<p>Disclose:</p> <ul style="list-style-type: none"> • the amounts used as the earnings numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the profit or loss for the period; and • the weighted average number of ordinary shares for both basic and diluted, and a reconciliation of those denominators to each other. <p>Encouraged to disclose the occurrence and nature of post-year end share transactions for which no adjustment is made eg post year end issues for cash.</p>	<p>Requirement are similar to the previous standard except that reconciliations to reported figures are now required to be disclosed.</p>
Presentation of additional earnings per share	<p>Denominator to be used should be determined in accordance with the rules of the Standard.</p> <p>If a component of net profit is used which is not reported as a line item in the profit and loss account, a reconciliation should be provided between the component used and a line item in the profit and loss account.</p>	<p>No significant change, except that the reason for presenting the additional figure is no longer required to be disclosed.</p>

Calculation of diluted earnings per share where the company has granted options to subscribe for equity shares of the company.

Earnings	\$5,000		
Number of shares in issue	4,000		
Options outstanding	1000 shares @ \$10		
Average market price	\$12.50		
Yield on HK deposit	5%		
		SSAP 5 (Original)	SSAP 5 (Revised)
No. of shares			
- excluding options		4,000	4,000
- on exercise of option		1,000	-
- assumed issue at nil considerations (note)		<u>-</u>	<u>200</u>
Total		<u>5,000</u>	<u>4,200</u>
Earnings		5,000	5,000
Notional return on assumed proceeds (10,000 @ 5%)		<u>500</u>	<u>-</u>
		<u>5,500</u>	<u>5,000</u>
Diluted earnings per share		1.1	1.19

Note: Proceeds on exercise of options

\$10,000

Number of shares assumed to be issued at fair value

$$\frac{10,000}{12.50} = 800$$

Number of shares assumed to be issued for nil consideration

$$1,000 - 800 = 200$$