

## Accounting Answers: Diluted EPS FAQs

We get a *lot* of questions about diluted earnings per share (EPS) calculations. So, we thought we'd recap some of the most common question and the answers. But feel free to send in other questions as well, we love Diluted EPS! While you're reading this, you also may want to check out our other articles on ["Diluted EPS: Treasury Stock Method Overview"](#) and ["Diluted Earnings Per Share: Reconciling Weighted Shares Outstanding"](#), which highlight a key methodology used in calculating Diluted EPS.

### Question #1 (Most Frequently Asked Question): Why are my "In-the-money" Options anti-dilutive?

Equity awards can be anti-dilutive when a) they are underwater OR b) the number of shares that can be repurchased by the company (aka "Buyback Shares") exceeds the number of weighted shares outstanding. Remember that part of the Treasury Stock Method under FASB ASC 260 is to calculate the number of shares the company can buy back on the open market using the hypothetical proceeds from the award. If the company can buy back more shares than there are outstanding, then the impact on EPS would be to increase the EPS rather than reduce it, which is counterintuitive to FASB ASC 260. In other words, if the impact of a grant would increase EPS instead of lowering (diluting) it, the grant is excluded from the Diluted EPS calculation. An excerpt from FASB ASC 260-10-45-17 states:

*"The computation of diluted EPS shall not assume conversion, exercise, or contingent issuance of securities that would have an antidilutive effect on earnings per share. [...] In determining whether potential common shares are dilutive or antidilutive, each issue or series of issues of potential common shares shall be considered separately rather than in the aggregate."*

Let's consider a simple example. Let's say for Q1 2017, you have 500 weighted average shares of common stock outstanding and you have \$1,000 in net income. Your Basic EPS would be calculated as  $\$1,000 \div 500$  shares or \$2 per share. Now let's add in an outstanding option for 100 shares. It was granted on the first day of the current period. Its exercise price is \$10 and the average market value during the period is \$11. Its Black Scholes fair value per share is \$8 and it's vesting (and therefore accruing expense) over one year.

Weighted Shares Outstanding- Options = 100 (outstanding for the entire quarter)

### Calculating Buyback Shares Using Assumed Proceeds:

#### A. Proceeds from Exercise Price

$(100 \text{ shares} * \$10 \text{ price}) \div \$11 \text{ average market value} = \mathbf{90 \text{ Buyback Shares (rounded down)}}$ .

Note: The hypothetical gain on exercise is \$1 (\$11 average market value - \$10 exercise price)- See Part C

#### B. Proceeds from the Average Unrecognized Expense Shares

$[(\$800 \text{ beginning unamortized expense} + \$600 \text{ ending unamortized expense}) \div 2] \div \$11 \text{ average market value} = \mathbf{63 \text{ Buyback Shares (rounded down)}}$

#### C. Proceeds from Tax Benefit Shares<sup>(1)</sup>

$[100 \text{ shares} * ((\$1 \text{ gain} - \$8 \text{ Black Scholes fair value}) * 40\% \text{ corporate tax rate})] \div \$11 \text{ average market value} = \mathbf{-25 \text{ Buyback Shares (rounded down. Tax deficiency or shortfall)}}$

#### D. Sum of (A + B +/- C) = 90 + 63 - 25 = 128 Buyback Shares before adoption of FASB ASU 2016-09 or (A + B) = 153 Buyback Shares after adoption of FASB ASU 2016-09.

(1)- **Note:** If your company has adopted FASB ASU 2016-09, which was released in March 2016, exclude the Tax Benefit Shares from the Diluted EPS calculations since under FASB ASU 2016-09, tax benefits (and deficiencies) are recorded to the income statement and included in the Diluted EPS numerator. See our "[Diluted EPS: Treasury Stock Method Overview](#)" and "[FASB ASU 2016-09: Amendments to ASC 718](#)" articles for details.

**Before adoption of FASB ASU 2016-09:** 100 weighted avg. options outstanding less 128 Buyback Shares = -28 Shares

**After adoption of FASB ASU 2016-09:** 100 weighted avg. options outstanding less 153 Buyback Shares = -53 Shares

If you add the -28 shares (or -53 shares) to the 500 weighted avg. shares of common stock outstanding, you get 472 shares (or 447 shares). Now when you divide Net Income by the Weighted Avg. Common Stock Outstanding + Common Equivalents, you get  $\$1,000 \div (500-28) = \$2.12$  Diluted EPS (or  $\$1,000 \div (500-53) = \$2.24$  Diluted EPS). Recall above Basic EPS was only \$2. The existence of an outstanding option has made the Diluted EPS look *better* than the Basic EPS - going against the most important premise of FASB ASC 260. So, any grant in which Buyback shares are greater than weighted shares outstanding is excluded from the Diluted EPS calculation. Hence in-the-money grants CAN be anti-dilutive.

(Note: this occurs most often early in the life of a grant, when there is a lot of unamortized compensation expense and therefore more Buyback shares that can be hypothetically repurchased by the company.)

**Question #2: RSAs, PSAs, RSUs, PSUs & Market condition RSUs- how and why are they anti-dilutive?**

**SOS Response:** RSAs, PSAs, RSUs, PSUs and Market Condition RSUs can be anti-dilutive for a couple of reasons:

1) IRC Section 83(b) Elections- if a Section 83(b) election is filed at the time of grant for a RSA or PSA, then the company will usually not be entitled to a tax deduction when the shares are vested/released. Thus, no Tax benefit shares can be calculated. Generally, there is no Section 83(b) elections for RSUs/PSUs as those are units and not actual shares of common stock.

2) No Exercise proceeds. RSUs/PSUs/Market-condition RSUs are usually granted with a \$0 exercise price (they're not stock options). These types of grants are usually granted with no consideration required to be paid by the recipient. They mostly require a certain period of employment and/or achieving certain performance/market metrics (i.e. company, individual or stock price/shareholder return metrics).

3) Proceeds from the Average Unrecognized Expense exceed the weighted average shares outstanding. This could be due to a higher amount of unrecognized expense early on in the vesting schedule, coupled with a lower average stock price during the period.

4) For PSUs and Market condition RSUs, because they are "*contingently issuable shares*" or shares that could be issued, some rules of thumb we often share with our clients are: "Do not include performance- or market-based awards in Diluted EPS until the performance- or market-based criteria is **actually** met. Being on track or ahead of schedule with company projections is OK for expensing purposes but **not** sufficient to include in Diluted EPS. At the end of the reporting period, ask yourself is the performance- or market-based criteria actually met or not?" Exclusion of these shares does not necessarily mean they are automatically anti-dilutive. It just means they were not included in the Diluted EPS calcs. Check out one of

our SOS Educational Webcasts, "[The Whole Enchilada: Accounting for PSUs from Top to Bottom](#)" which includes a section on Diluted EPS for performance- and market-based awards.

### **Question #3: Why do I have negative Buyback shares?**

**SOS Response:** Negative Buyback shares are a result of the math per the Treasury Stock Method and usually occur when the Tax Benefit Shares are so negative that they exceed the Buyback shares from both the Exercise Proceeds and Average Unrecognized Expense. This results in an estimated "tax deficiency" or "tax shortfall" which is when the taxable gain (intrinsic value) on exercise/release is significantly less than the grant date fair value (compensation expense) associated with those shares. You also have this comparison when comparing the deferred tax assets (DTAs) related to stock compensation based on expense recorded multiplied by the corporate tax rate vs. the actual tax deduction realized. Under FASB ASU 2016-09 which was released in March 2016, tax benefits and tax deficiencies are now recorded to the income statement (no longer to the APIC Pool on the Balance Sheet) and thus they will be included in the Diluted EPS numerator of Net income (loss). Therefore, as noted above and to not double count, if your company has adopted FASB ASU 2016-09, this Tax benefit shares bucket has been removed from the Diluted EPS calculation using the Treasury Stock Method and companies no longer need to worry about it.

### **Question #4: Why is unamortized/unrecognized expense included in the assumed proceeds?**

**SOS Response:** To make a long answer short, the FASB has indicated that the unamortized/unrecognized expense is compensation expense that has been measured for future services but that has not yet been recognized. As such it is required to be included as part of the Treasury Stock Method. If someone knows a better, more convincing answer, please do share!

### **Question #5: Why are my performance grants not showing on my Diluted EPS reports? We are on track to hitting the performance metrics.**

**SOS Response:** As noted briefly above in Question #2, there are a couple rules of thumbs when it comes to performance awards and Diluted EPS. You likely don't see the performance awards on the Diluted EPS reports, because not all of the contingencies (i.e. the performance targets and service requirements) have been met yet as of the end of the reporting period. Refer to the paragraphs in FASB ASC 260-10-45-50 through 54. It is possible that contingently issuable shares could be included in Diluted EPS one quarter and not included in the following quarter. This can result in some volatility in your company's Diluted EPS calculations. Beware, as analysts and shareholders often rely heavily on a company's financial performance by looking at Basic and Diluted EPS.

### **Question #6: Should we include "Out-of-the-money" options in our Diluted EPS calcs?**

**SOS Response:** As "Out-of-the-money" options have exercise prices that are greater than the average market price, a participant would not normally exercise those options. Therefore, "Out-of-the-money" options should not be included in the Treasury Stock Method. You can already mark those options as anti-dilutive.

### **Question #7: How should early exercised options be treated in the Diluted EPS Calcs?**

**SOS Response:** If the early exercised options are vested, the shares should be reflected in Basic EPS. If the early exercised options are unvested, the Treasury Stock Method should be used to determine any dilutive shares with one caveat... there are no Buyback shares from assumed Exercise Proceeds because the participant already exercised the options. Keep in mind, shares that are early exercised are outstanding from a legal/tax perspective, but are not outstanding (and not exercised) from an accounting perspective until they are vested.

**Question #8: What about shares from our ESPP Plan? Should those be included in Diluted EPS?**

**SOS Response:** In our experience, most ESPP Plans require the participants to be actively employed and participating in the ESPP Plan on the day that ESPP shares are purchased. Therefore, ESPP shares are technically considered “*contingently issuable shares*” under the FASB ASC 260 guidance. However, we do not see many examples where ESPP options (yes, an option is granted on the ESPP offering begin date) are included in Diluted EPS because of immateriality. We do see examples where the ESPP shares purchased are included in Basic EPS but only after the shares are purchased. Depending on facts and circumstances of your ESPP Plan, if the ESPP Plan is “material” and not subject to much change due to withdrawals and terminations, you may want to consider whether estimated ESPP shares should be included in Diluted EPS.

This summary is intended only for a high-level overview. It is not intended to be accounting or tax advice. SOS recommends its clients consult their qualified accounting and tax advisors before taking action in order to understand the impact accounting guidance will have on their company’s stock based compensation accounting, tax, financial reporting and equity systems/databases.

If you have any more questions on Diluted EPS, please do not hesitate to reach out to us. Email us at [info@sos-team.com](mailto:info@sos-team.com) or give us a call at (408) 979-8700 and ask to speak with one of our SOS Accounting Pillars. We’ll be happy to discuss this further with you.

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