ACCOUNTING ANSWERS: DILUTED EPS FAQS

I get a *lot* of questions about diluted earnings per share (EPS) calculations. A lot. Maybe one or two per day, during certain seasons. For the next few Xtra's, we thought we'd recap some of the most common question and the answers. (But feel free to send in other questions as well, I love diluted EPS!)

Number 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 buyback shares exceeds the number of weighted shares outstanding. Remember that part of the Treasury Stock Method under ASC 260 is to calculate the number of shares you can buyback on the open market using the hypothetical proceeds from the award. If you can buyback more shares than are outstanding, then the impact on EPS would be to increase the EPS rather than reduce it, which flies in the face of the underlying purpose of the diluted EPS calculation - to show how low your EPS would be if all your potentially dilutive instruments were to become common stock. If the impact of a grant would be to drive EPS higher instead of lower, the grant is excluded. ASC 260-10-45-17 (formerly paragraph 13 of FAS 128) 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 you have 500 shares of common stock outstanding and you have $1,000 in net income. Your basic EPS would be calculated as $1000 ÷ 500 shares or $2 basic EPS. Now let's add in an outstanding option for 100 shares. It was granted on the first day of the current period. Its price is $10 and the average market value during the period is $11. Its fair value per share is $8 and it's vesting (and therefore accruing expense) over one year.
Weighted Shares Outstanding = 100

Buyback Shares
Exercise Proceeds
(100 shares * $10 price) ÷ $11 average market value = 91 Shares
Tax Benefit Shares
(100 shares * (($1 gain - $8 fair value) * 40% corporate tax rate)) ÷ $11 average market value = -25 Shares
Average Unamortized Expense Shares
(($800 beginning unamortized expense + $600 ending unamortized expense) / 2) ÷ $11 average market value = 64 Shares
100 Outstanding shares less 130 Buyback Shares (91-25+64) = -30 Shares
Add the -30 shares to the 500 shares of common stock outstanding and you get 470 shares.
Now when you divide Net Earnings by Common Stock Outstanding + Common Equivalents, you

get $2.13. The existence of an outstanding option has made the diluted earnings per share look *better* than the basic EPS - going against the most important premise of ASC 260. So any grant in which buyback shares is greater than weighted shares outstanding is excluded from the 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 expense and therefore a lot of buyback shares.)

In the upcoming months we will cover questions such as:

RSUs & PSUs - how and why are they anti-dilutive?
Why do I have negative buyback shares?

Why is unamortized expense included?

Why are my performance grants not showing on my diluted EPS reports?

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Elizabeth regularly speaks on industry trends and product development at client and industry events including NASPP and NCEO webcasts, GEO and NASPP Chapter meetings, and the NASPP Annual Conference. She was also selected to speak at the West Coast FASB Roundtable on FAS 123(R) and co-authors the chapter on accounting for equity compensation in The Stock Options Book, by Alisa Baker. She became a Certified Equity Professional in 1999 and continues to volunteer for the Certified Equity Professional Institute as well as serving on the CEPI Curriculum Committee. She is also the president of the Silicon Valley Chapter of the NASPP and serves on the Board of Directors of the NCEO.

About Stock & Option Solutions

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