

**DILUTED EARNINGS PER SHARE:
RECONCILING WEIGHTED SHARES OUTSTANDING**

Recently, after helping a client with her diluted earnings per share calculations after an option exchange followed (six weeks later!) by a spin off, the client asked for help in reconciling the dilutive and anti-dilutive shares back to the original weighted shares outstanding.

On first glance, this may seem simple, since weighted shares outstanding should be neatly divided between dilutive and anti-dilutive buckets, right? Not so fast, grasshopper! As usual, there's more to these calculations than meets the eye... the total weighted shares outstanding are very unlikely to equal the sum of dilutive and anti-dilutive shares.

(This article assumes a thorough knowledge of the calculations for diluted EPS under the Treasury Stock method prescribed by ASC Topic 260 [formerly FAS 128]. If you need a better understanding of these basics, please email us and we'll be happy to write another article for Xtra.)

We'll now go through a series of four examples to illustrate some of the various reasons that this may be the case, and one way to reconcile the numbers despite this challenge.

Imagine for a moment that your life is much simpler than it really is and that you have a total 400 weighted shares outstanding, comprising (or "composed of") four grants of 100 shares each. The average market value of the stock during the period was \$10.

Grant #	Type	Price	Shares	Buyback Shares	Dilutive?	Dilutive Shares	Anti-dilutive Shares
A	NQ	\$8	100	70	Yes	30	0
B	NQ	\$12	100	30	No	0	100
C	NQ	\$8	100	120	No	0	100
D	RSU	\$0	100	-40	Yes	100	0

Regular Dilutive Grant

Grant A is our simplest example: an in-the-money NQ, where the buyback shares are less than the weighted shares outstanding. To determine the dilutive shares, you simply subtract the buyback shares from the weighted shares outstanding to determine the dilutive shares.

Anti-dilutive: Underwater Option

Grant B has a price of \$12, so it is automatically excluded from the calculation as anti-dilutive. Most systems will not calculate any buyback shares for this grant. However, whether your system shows zero buyback shares for underwater options or does calculate buyback shares for these underwater grants, the ultimate result is the same: all the weighted share outstanding in the grant are anti-dilutive.

Anti-dilutive: Buyback Shares Exceed Weighted Shares Outstanding

Grant C is an in-the-money NQ, where the buyback shares are greater than the weighted shares outstanding. The grant is therefore anti-dilutive and all the weighted shares outstanding are part of the anti-dilutive shares.

Negative Buyback Shares

This is a common situation for RSUs where the market value has dropped between the grant date and the current period.

For Grant D, the grant is an RSU so is always in-the-money, but when the buyback shares are calculated, the total buyback shares are a negative number. This can result from situations where the fair value of the grant exceeds the “in-the-moneyness” of the grant. For Grant B, let’s say that the fair value of the grant is \$12 (granted when the stock price was higher than it is today). The Tax Benefit Shares would be calculated as the gain per share of \$10 (\$10 market value less \$0 price) less the \$12 fair value. The result is a negative \$2 per share (before being multiplied by the applicable tax rate). The exercise proceeds are zero because the grant is an RSU, so unless the grant has enough proceeds from the average unamortized expense during the period, the tax benefit shares would be negative. (Total negative buyback shares may also occur in other, less common scenarios.)

This grant is dilutive since the weighted shares outstanding are greater than the buyback shares. However, if you were to *subtract* the buyback shares from the weighted shares outstanding, as for a “normally” dilutive grant, you’d end up with 140 dilutive shares. But dilutive shares cannot *exceed* weighted shares outstanding, so you would not subtract, and the entire 100 shares would be part of the dilutive shares.

Reconciling

To compute the total dilutive or anti-dilutive shares, first compute the impact that the buyback shares would have on the dilutive shares grant-by-grant. If the grant is underwater or the buyback shares are greater than the weighted shares outstanding, the impact is equal to the total weighted shares outstanding (all are anti-dilutive). If the total buyback shares are negative, the impact is 0. Otherwise the impact to dilutives shares is equal to the buyback shares. So your formula might look something like this:

Impact of Buyback Shares on Dilutive Shares

IF Price > Average Market Value

 Then Weighted Shares Outstanding

 Else

 IF Buyback Shares < 0

 Then 0

 Else

 IF Buyback Shares <= Weighted Shares Outstanding

 Then Buyback Shares

In our examples above the results would be as follows:

Grant #	Type	Price	Weighted Shares Outstanding	Buyback Shares	Impact on Dilutive Shares	Dilutive Shares	Anti-dilutive Shares
A	NQ	\$8	100	70	70	30	0
B	NQ	\$12	100	30	100	0	100
C	NQ	\$8	100	120	100	0	100
D	RSU	\$0	100	-40	0	100	0
			400		270	130	200

Now you can sum the weighted shares outstanding (400), sum the Impact of Dilutive shares (270) and subtract the totals of those amounts to reconcile to the total Dilutive Shares (130).

To reconcile the anti-dilutive shares, simply sum the weighted shares column only if the Price is greater than the Average Market Value OR if the Buyback Shares are greater than the Weighted Shares Outstanding.

Please contact me with questions on the calculations or this article,
 Elizabeth Dodge
edodge@sos-team.com

Elizabeth is the Vice President of Product Management for Stock & Option Solutions, Inc. (SOS). Her responsibilities include monitoring new developments in the equity compensation arena, performing market research, speaking at industry events and helping to define the product roadmap for SOS.

Elizabeth regularly speaks on industry trends and product development at client and industry events including NASPP and NCEO webcasts, GEO and NASPP Chapter meetings, User Groups, and the NASPP Annual Conference. She was also selected to speak at the West Coast FASB Roundtable on FAS 123(R) and has recently co-authored the chapter on accounting for equity compensation in The Stock Options Book, 11th edition, by Alisa Baker. She became a Certified Equity Professional in 1999 and continues to volunteer for the Certified Equity Professional Institute. She also volunteers for the Silicon Valley Chapter of the NASPP and the NCEO.

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