

## Diluted EPS: Treasury Stock Method Overview

While reading this whitepaper, please check out our other articles, [“Diluted Earnings Per Share: Reconciling Weighted Shares Outstanding”](#), [“Accounting Answers: Diluted EPS FAQs”](#) and [“FASB ASU 2016-09: Amendments to ASC 718”](#) to further your understanding on Diluted Earnings Per Share (EPS) calculations as they relate to equity compensation. For this whitepaper, we will focus on time-based stock options and restricted stock awards/units (RSAs/RSUs).

Under Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 260 (FASB ASC 260), companies must report Diluted EPS using the "Treasury Stock Method"<sup>(1)</sup>. The Treasury Stock Method requires the following assumptions:

- 1) exercise of stock options shall be assumed at the beginning of the period or at the time of issuance and common stock shall be assumed to be issued (think weighted average shares outstanding),
- 2) the proceeds from exercise shall be assumed to be used by the company to repurchase some or all of those issued shares at the average market price during the period (think "Buyback Shares"), and
- 3) the incremental shares (difference between the number of shares assumed issued and the number of shares assumed purchased) shall be included in the denominator of the Diluted EPS computation.

If your company is privately-held, you will likely have to utilize the fair market value(s) from your 409A Valuations during the respective time periods to determine your estimate of the average market price.

Generally, SOS breaks this process down into 5 "easy" steps:

**Step 1. Exclude underwater or “out of the money” options.** Underwater options would increase rather than decrease the dilutive impact of your equity instruments, thus these grants should be excluded from the calculation. These shares are considered Part 1 of the shares that are "anti-dilutive". But grants can be anti-dilutive without being underwater. See step 4, below.

**Step 2. Weight shares for time outstanding during period (WSO).** This is straight-forward if you are dealing with a grant or a cancellation during the period, but becomes more complicated if you have multiple transactions for a single grant. In some cases, it may be acceptable to simplify the calculation and simply use  $(\text{Beginning shares outstanding} + \text{Ending shares outstanding}) \div 2$ .

**Step 3. Calculate Assumed Proceeds & Buyback Shares.** As of the date of this whitepaper, there are three sources of assumed proceeds, per FASB ASC 260<sup>(2)</sup>, but please note one of the assumed proceeds (C) is being phased out due to simplified accounting guidance that was released in March 2016.

(A) Proceeds from Exercise Price: This is the actual money the employee must pay the company at the time of the hypothetical exercise. The calculation is simply  $\text{WSO} \times \text{Exercise Price}$ . For RSAs and RSUs, those generally don't have an exercise price, thus proceeds are zero for those types of awards.

(B) Proceeds from the Average Unrecognized Expense During the Period: This is the amount of compensation cost related to future services and not yet recognized. This is probably the most difficult assumed proceed to explain and understand, but just know that it's included because the FASB included it in the Treasury Stock Method. This is generally calculated using the  $(\text{Beginning unamortized expense} + \text{Ending unamortized expense}) \div 2$ . However, note this simple calculation may need to be pro-rated for grants that are issued and/or cancelled during the same period.

**Note:** This next assumed proceed is being phased out due to simplified accounting guidance in FASB Accounting Standard Update (ASU) 2016-09. In short, if your company has adopted **FASB ASU 2016-09**, this Tax benefit assumed proceed is eliminated from the Treasury Stock method because tax benefits and

deficiencies are to be reflected in the income statement, thus included in the Diluted EPS numerator. If your company has not adopted ASU 2016-09 yet, then the tax benefit calculations below will still need to be performed. Please see our SOS overview of this simplified accounting guidance for more details<sup>(3)</sup>.

(C) *Proceeds from Tax benefit*: This source of assumed proceeds reflects the assumed tax deduction that will be recognized by the company at the time of the hypothetical stock option exercise or RSA/RSU release. Calculate the gain from the hypothetical exercise/release by subtracting exercise price (if any) from the average market value during the period. If there is no gain, the number is set to zero. Then subtract the grant date fair value (expense) on the exercised/released shares. This number could be a negative number if the hypothetical gain on exercise is less than the grant date fair value for the award. This means the company has a tax shortfall or tax deficiency, which is treated as a "reduction to assumed proceeds" per FASB ASC 260.

(D) Take the Sum of the 3 components above  $(A + B +/- C) \div \text{Average Market Value} = \text{Total "Buyback Shares"}$ . This is roughly how many shares the company could hypothetically buy back to soften the impact if all outstanding options, and RSAs/RSUs were assumed issued.

**Step 4. If Buyback Shares > Weighted Shares Outstanding = Anti-dilution**, exclude the grant just like Step #1 above. Since the Buyback Shares exceed the Weighted Shares Outstanding, the result would increase, rather than decrease Diluted EPS, which is counterintuitive to FASB ASC 260. So any grants that fall into this category is Part 2 of the shares that are "anti-dilutive" and are also excluded from the calculation.

**Step 5. If Weighted Shares Outstanding > Buyback Shares = Some or All Dilution**, then the difference between those figures are the dilutive shares to add to the Basic EPS denominator to arrive at the Diluted EPS calculation.

Finally, please note that in addition to the reconciliations of the numerators and denominators for Diluted EPS, shares that are considered anti-dilutive (Steps #1 and #4) are required to be disclosed in the company's footnote on EPS<sup>(4)</sup>.

#### Footnotes

(1) FASB ASC 260-10-45-23

(2) FASB ASC 260-10-45-29

(3) SOS Accounting Update: [FASB ASU 2016-09: Amendments to ASC 718](#)

(4) FASB ASC 260-10-50-1

Questions or comments? Please email us at [xtra@sos-team.com](mailto:xtra@sos-team.com)

### About Stock & Option Solutions

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*This article was originally published October 2013 and last updated in August 2017.*