Treasury Stock Overview

Under ASC 260, to calculate Diluted Earnings per Share (EPS), you must use the "Treasury Stock Method". The Treasury Stock Method requires that you assume all potentially dilutive instruments are both fully vested and exercised immediately to determine their impact on the earnings per share of the company. This worst case scenario is then mitigated by using the "assumed" proceeds from the hypothetical exercise (or release) of the equity compensation instrument to "buy back" shares on the open market, using the average market value of the stock during the reporting period.

Generally we break this process down into 5 "easy" steps:

1. Exclude underwater options
   Because underwater options would *increase* rather than *decrease* the dilutive impact of your equity instruments, these grants are excluded from the calculation. These are considered "anti-dilutive" grants. But grants *can* be anti-dilutive without being underwater. See step 4, below.
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 (beginning shares outstanding + ending shares outstanding) / 2.
3. Calculate exercise proceeds & "buyback shares"
   There are three sources of assumed proceeds, per ASC 260.
   A. Exercise price:
      This one is fairly simple to understand and very easy to calculate. This is the actual money received for the exercise price for options at the time of hypothetical exercise. The calculation is simply weighted shares outstanding * exercise price. Obviously for restricted stock/restricted stock units (which don't generally have an exercise price), this is zero.
   B. Tax benefit:
      This source of assumed proceeds reflects the tax benefit that will be recognized by the company at the time of exercise or release. First you calculate the hypothetical 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 the grant date fair value is subtracted. This number *can* be a negative number when/if the hypothetical gain on exercise is less than the grant date fair value for the award. This reflects the possibility of a "shortfall" or tax deficiency and is treated as a "reduction to assumed proceeds" per ASC 260.
   C. Average Unamortized Expense during the Period:
      This is the most difficult assumed proceed to explain. Clients have asked again and again why this is included as a "proceed from exercise" and we've never heard a thoroughly convincing answer. We include it because it's part of the applicable accounting standard, whether it makes intuitive sense to include it or

not. This is generally calculated using the beginning unamortized expense added to the ending unamortized expense and divided by two.

D. Sum 3 components (A + B + C) /Average Market Value = total "buyback shares"

4. If buyback shares > Weighted Shares Outstanding (anti-dilutive), exclude grant
Just like step 1, above, if the buyback shares exceed the Weighted Shares Outstanding the result would increase, rather than decrease the diluted EPS, which again is counter to the purpose of ASC 260. So any grants that fall into this category are excluded.
5. Weighted shares outstanding minus buyback shares = dilutive shares to include in diluted EPS calc in addition to common stock.

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Elizabeth is the Vice President of Product Management for Stock & Option Solutions, Inc. (SOS). She also runs the Strategic Solutions and Accounting Solutions groups. Her responsibilities include monitoring new developments in the equity compensation arena, performing market research, speaking at industry events and helping SOS clients with all kinds of equity compensation challenges.

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