Earnings per share

Handbook

US GAAP

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Contents

The complicated common metric, Earnings Per Share

EPS is a metric used by public companies, investors and others to measure or monitor a company's earnings and trends. While certain public companies may have their own industry-related or company-specific metrics, EPS is a required, and therefore common, metric amongst all public companies.

Since the FASB released its initial guidance on EPS in 1997 (now contained in Topic 260), it has been largely untouched. EPS calculations can be relatively straightforward for simple capital structures. But more complex instruments – such as those that contain conversion features or contingencies, or share-based payment awards – or more complex capital structures often create a trickier EPS calculation. In addition, the EPS requirements around participating securities can be challenging.

This Handbook explains the principles of Topic 260 through Q&As and examples, using a step-by-step approach to lead you through the calculations and applying them to more complex instruments. We have organized this Handbook to make it easy to find the steps needed for the EPS calculation. We also discuss many instruments and scenarios that are not directly addressed in Topic 260.

Mahesh Narayanasami and Rivka Grund-Sender
Department of Professional Practice, KPMG LLP

About this publication

The purpose of this Handbook is to assist you in presenting and disclosing earnings per share (EPS) information under the requirements in Topic 260 and related SEC guidance.

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant FASB requirements for EPS information. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include observations and examples to explain key concepts.

Our commentary is referenced to the Codification, SEC regulations and to other literature, where applicable. The following are examples.

— 260-10-50-1 is paragraph 50-1 of ASC Subtopic 260-10.

— FAS 128.BC112 is paragraph 112 of the basis for conclusions to FASB's Statement of Financial Accounting Standards No. 128.

— FTB 97-1 is FASB Technical Bulletin number 97-1.

— Reg S-X is SEC Regulation S-X.

— S-X Rule 5-03(21) is paragraph 21 of Rule 5-03 of SEC Regulation S-X.

— SEC FRM 7520.2 is Section 7520.2 of the SEC's Financial Reporting Manual.

— 2014 AICPA Conf is the 2014 AICPA National Conference on Current SEC and PCAOB Developments. These references are hyperlinked to the source material on the SEC's website.

— SAB Topic 1.B.3 is the SEC Staff Accounting Bulletin Topic 1.B.3.

— TQA 7100.03 is section 7100.03 of the AICPA's Technical Questions and Answers.

Assumptions and conventions in Q&As and examples

The guidance in this Handbook assumes the following, unless otherwise noted.

— There is no noncontrolling interest in the entity.
— Income available to common shareholders refers to consolidated net income.
— There is one diluted EPS measure (i.e. no discontinued operation).
— Potential common shares are not participating securities.

EPS calculations in this Handbook are prepared for discrete annual periods for illustrative purposes. In practice, an entity that presents EPS on a quarterly basis calculates the denominator for year-to-date and annual periods following the year-to-date guidance in section 8.3.30.

Recent ASUs

Accounting Standards Update 2020-06

In August 2020 the FASB issued Accounting Standards Update (ASU) 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity.

The effective dates for ASU 2020-06 are as follows.

	Public business entities that meet the definition of an SEC filer[1]	Other entities
Each amendment will be effective:	For annual and interim periods in fiscal years beginning after December 15, 2021	For annual and interim periods in fiscal years beginning after December 15, 2023
Early adoption:	Permitted, but no earlier than annual and interim periods in fiscal years beginning after December 15, 2020	
Note: 1. SEC filers for this purpose excludes entities eligible to be smaller reporting companies, as defined by the SEC.		

Within this ASU, the FASB chose to simplify EPS calculations for convertible instruments and made the following primary changes.

Amended requirements	Current GAAP	Book reference
All convertible instruments are included in diluted EPS using the if-converted method.[1] However, when the principal is required to be settled in cash, the interest charges are not added back to the numerator.	Certain convertible instruments are included in diluted EPS using the treasury stock method. These include, for example, convertible instruments for which the accreted value is required to be settled in cash and the conversion premium may be settled in any combination of cash or shares.	Section 6.12 Section 6.13
Instruments that may be settled in cash or shares, are included in diluted EPS presuming share settlement, if the effect is more dilutive, with no option for rebutting that presumption. There is an exception, for liability-classified share-based payment awards, for which the share-	If the decision to settle in cash or shares is at the issuer's option, the share settlement presumption may be rebutted based on past experience or a stated policy.	Section 6.13

Amended requirements	Current GAAP	Book reference
settlement presumption may be rebutted based on past experience or a stated policy.		
The effects of a down-round feature in convertible preferred stock (if the conversion feature has not been bifurcated under other guidance) is measured as the difference in the fair value of the instrument before and after the down-round feature is triggered, and is only recorded and reflected in EPS when it is triggered.	Currently this guidance only applies to an equity-classified freestanding financial instrument. In contrast, for convertible preferred stock with a down-round feature, the beneficial conversion feature model applies to measure the feature when triggered, and the effect may be recognized in EPS over several periods (depending on the instrument's terms).	Section 3.3.60 Section 6.18
Note: ASU 2020-06 retains the provisions of paragraph 260-10-55-11, which requires the treasury stock method be used to determine the denominator adjustment for convertible instruments that permit or require the payment of cash by the holder at conversion. The if-converted method is used to calculate the numerator adjustment.		

In addition to the simplification of EPS calculations for convertible instruments mentioned above, the ASU clarifies the following.

EPS topic	Amended requirements	Book reference
Variable incremental shares when applying the if-converted method to convertible preferred stock or convertible debt	When the conversion rate or exercise price of an instrument varies due to changes in an entity's share price, the average market price for the period is used to determine the shares for the diluted EPS denominator. However, this approach does not apply to contingently issuable shares.	Chapter 4 Section 6.12 Section 6.14 Section 6.15 Section 6.16
Year-to-date share computations	When calculating diluted EPS for the year-to-date period, the denominator is based on a weighted-average share count for each quarter, subject to certain existing exceptions (e.g. when there is a loss).	Chapter 8

This Handbook has been updated for the effects of ASU 2020-06, and the amendments that the ASU has made to the Codification are displayed as current content in the excerpts within this Handbook. Appendix A includes the guidance for select sections applicable to entities that have not yet adopted ASU 2020-06.

Accounting Standards Update 2023-06

In October 2023, the FASB issued ASU 2023-06, *Disclosure improvements: Codification amendments in response to the SEC's disclosure update and simplification initiative*, which incorporates into the Codification several disclosures and presentation requirements currently residing in SEC Regulations S-X and S-K. As a result, the ASU is not expected to significantly affect entities already subject to these SEC requirements. However, certain disclosures currently presented outside the financial statements as a result of Reg S-K may need to be relocated into the financial statements. Conversely, the ASU adds certain requirements for private and not-for-profit entities (as they were not previously subject to the requirements in Reg S-X and S-K).

The amendments the ASU has made to the Codification are displayed as pending content in the excerpts within this Handbook.

The effective dates for ASU 2023-06 are as follows.

	Entities subject to the SEC's existing disclosure requirements[1]	**Other entities**
Each amendment will be effective:	As of the effective date to remove the related disclosure requirement from Reg S-X or S-K.	Two years later
	If by June 30, 2027, the SEC has not removed the existing disclosure requirement from Reg S-X or S-K, the corresponding pending requirement will be removed from the Codification and will not become effective for any entity.	
Early adoption:	Not permitted	

Note:

1. Entities subject to the SEC's existing disclosure requirements and entities required to file or furnish financial statements with or to the SEC in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

January 2025 edition

This version of our Handbook includes new and updated interpretations based on our experience with companies applying Topic 260. New Questions and Examples are identified with ** and items that have been significantly updated or revised are identified with #. The Index of changes identifies all significant changes.

Abbreviations

We use the following abbreviations in this Handbook:

AcSEC	Accounting Standards Executive Committee
APIC	Additional paid-in capital
EPIS	Earnings per incremental share
EPS	Earnings per share
EPU	Earnings per unit
ESOP	Employee stock ownership plan
ESPP	Employee share purchase plan
GP	General partner
IDR	Incentive distribution right
LP	Limited partner
MLP	Master limited partnership
NCI	Noncontrolling interest
PCS	Potential common share
REIT	Real estate investment trust
RSU	Restricted stock unit
SPAC	Special purpose acquisition company

1. Executive summary

EPS is a performance measure indicating the amount of income during a reporting period that is attributable to each common share and potential common share. A potential common share is a security or other contract that may entitle its holder to obtain common shares (common stock).

Topic 260 prescribes certain principles for determining and presenting EPS. There are two types of EPS information.

— **Basic EPS** is presented when an entity has common shares outstanding. Basic EPS is income for the period divided by the common shares outstanding for EPS purposes.

— **Diluted EPS** is presented when an entity has both common shares and dilutive potential common shares outstanding. Diluted EPS is basic EPS adjusted for the theoretical effect of the conversion or exercise of potential common shares outstanding.

This Handbook explains the foundational principles for calculating EPS and the numerous associated nuances.

Scope

Topic 260 requires presentation of EPS information by entities that have issued common shares or other securities that are considered potential common shares.

EPS information is required for common shares or potential common shares when:

— these shares trade are in a public market;
— these shares will be part of a securities offering in a public market and the entity is in the process of making a filing to facilitate the securities offering; or
— the entity is an MLP.

In addition, an entity that is not required to present EPS information but chooses to is required to follow the presentation and disclosure guidance in Topic 260.

Read more: Chapter 2

Basic EPS – The foundations

Basic EPS indicates the amount of income from a reporting period that is available to each common share.

EPS is a ratio, calculated as follows:

— **numerator:** income available to common shareholders; and

— **denominator:** weighted-average number of common shares outstanding during the reporting period.

Determining the numerator requires adjustments to income (loss) for returns on other classes of equity instruments. Determining the denominator requires identifying which shares should be treated as common shares and when they are outstanding during the reporting period.

Read more: Chapter 3

Diluted EPS – The foundations

Diluted EPS includes not only common shares outstanding but also shares that would be issued assuming the exercise and conversion of potential common shares.

To determine diluted EPS, adjustments are made to the numerator and/or denominator of basic EPS to reflect the income and weighted-average number of shares that would have existed had the potential common shares been common shares during the entire period; or for the period of time that the potential common shares were outstanding.

Potential common shares are not included in diluted EPS if they are antidilutive – i.e. the exercise or conversion would increase EPS. Because an entity needs to determine whether each class of potential common shares is antidilutive, the calculation of diluted EPS requires a step-by-step approach.

Read more: Chapter 4

Participating securities and the two-class method

The two-class method is used to determine income available to common shareholders when an entity has a multilayered capital structure containing different types of securities with the right to participate in earnings.

A multilayered capital structure can contain instruments such as:

— participating equity securities – i.e. equity securities that participate in dividends with common shares according to a predetermined formula; and/or

— a class of common shares with a dividend rate different from that of another class of common shares but without prior or senior rights.

The numerator in the basic EPS calculation is adjusted for the effects of these instruments because they may reduce the entitlement of common shareholders to the entity's income. The adjustment is determined by applying the two-class method.

Read more: Chapter 5

Consideration of specific instruments

Calculating basic and diluted EPS often requires taking numerous types of equity instruments and potential common shares into account. Each type of relevant instrument requires a separate analysis to determine its effect on EPS.

This Handbook discusses how to deal with the following types of instruments or events in EPS calculations:

- common shares issued in full for cash or partially paid;
- stock dividends, splits and rights issues;
- common shares issued to settle liabilities or acquire assets (including a business);
- unvested common shares (including restricted stock);
- options, warrants and forward sale contracts;
- contingently issuable common shares and potential common shares (and shares subject to recall);
- convertible instruments;
- contracts that may be settled in shares or in cash;
- preferred shares;
- written put options and forward purchase contracts;
- purchased puts and calls;
- instruments over shares in, or issued by, a subsidiary, joint venture or equity method investee;
- equity-classified instruments with a down-round feature.
- employee stock ownership plans
- employee stock purchase plans

Read more: Chapter 6

Retrospective adjustments

EPS for comparative periods is retrospectively adjusted in certain circumstances.

EPS is retrospectively adjusted for comparative periods when a change in an entity's capital structure results in a change in the number of outstanding common shares without a corresponding change in the entity's resources or capital base.

Examples include:

- issuance of a stock dividend, stock split or reverse stock split;
- issuance of a rights issue with a bonus element to all existing shareholders;
- consummation of a reverse acquisition or a business combination of entities under common control;
- an accounting change that is applied retrospectively or error correction.

Read more: Chapter 7

EPS in interim financial statements

Topic 260 applies to interim financial statements.

The extent to which Topic 260 applies to interim financial statements depends on the type of interim financial statements issued.

- **Full interim financial statements.** The same EPS presentation and disclosures that are required in annual financial statements regarding EPS information are required; this includes disclosures in Topic 270 (interim financial statements).
- **Condensed interim financial statements.** There are similar, but fewer, EPS disclosures than required for full interim financial statements and EPS information is required on the face of the condensed income statement.
- **Summarized interim financial data.** The disclosure requirements in Topic 270 are not applicable.

Read more: Chapter 8

Presentation and disclosure

Topic 260 requires presentation of and disclosures about EPS information for every period for which an income statement is presented.

An entity presents and discloses EPS information for every period for which an income statement is presented.

An entity also has specific disclosure requirements for the current period when a transaction has occurred after the reporting period, but before the financial statements are issued, that would have materially changed the number of common shares or potential common shares outstanding if it had occurred before the end of the period.

Read more: Chapter 9

MLPs

The general principles for calculating EPS also apply to an MLP's calculation of earnings per unit (EPU).

The general principles apply to the calculation of EPU by an MLP, Topic 260 provides guidance on how to apply those principles when the MLP treats payments to IDR holders as equity distributions. It also provides guidance specific to determining EPU after a dropdown transaction in which the general partner contributes assets to the MLP.

Read more: Section 9.3

2. Scope

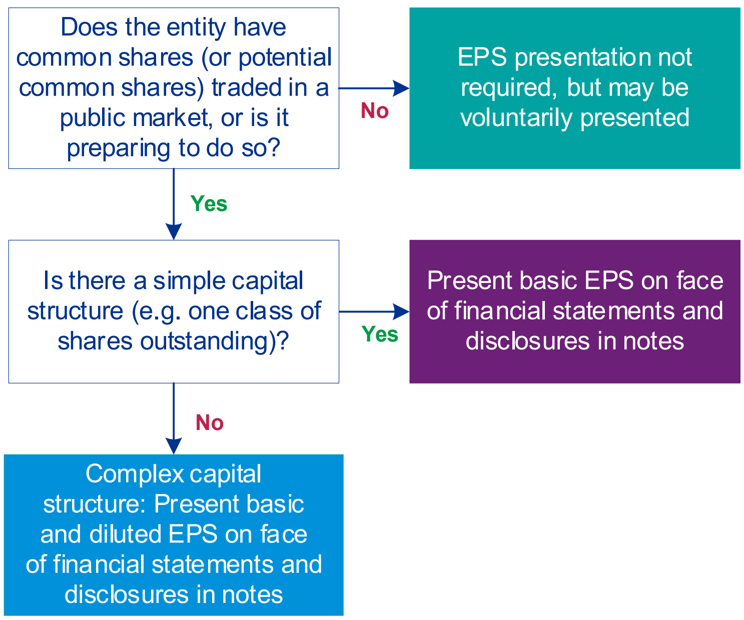
Detailed contents

Examples

2.1 How the standard works

Topic 260 requires presentation of EPS information by all entities that have issued common shares or other securities that are considered potential common shares if the shares trade in a public market. This applies to entities that have made a filing, or are in the process of making a filing, in preparation of the sale of such shares in a public market. MLPs also follow the requirements of Topic 260 in most instances.

This chapter explains the scope, presentation and disclosure requirements of Topic 260. The following are general guidelines for applying Topic 260.



Topic 260 applies to any entity that presents EPS information in its financial statements, even if the entity provides the disclosures voluntarily and is not otherwise in scope.

Topic 260 also applies to any disclosure of additional amounts per share that are calculated using a reported component of the financial statements – e.g. comprehensive income per share (see section 2.2.30 and chapter 9). EPS is used to report performance measures on a per-share basis, but cannot be used to present liquidity measures on a per-share basis (i.e. cash flows per share).

2.2 Mandatory presentation of EPS information

2.2.10 Entities required to present EPS

Excerpt from ASC 260-10

> Entities

15-2 The guidance in the Earnings per Share Topic requires presentation of earnings per share (EPS) by all entities that have issued **common stock** or **potential common stock** (that is, securities such as **options**, warrants, convertible securities, or contingent stock agreements) if those securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally. This Topic also requires presentation of EPS by an entity that has made a filing or is in the process of filing with a regulatory agency in preparation for the sale of those securities in a public market.

15-3 The guidance in this Topic does not require presentation of EPS for investment companies that comply with the requirements of Topic 946 or in statements of wholly owned subsidiaries. Any entity that is not required to present EPS in its financial statements that chooses to present EPS in its financial statements shall do so in accordance with the provisions of this Topic.

Topic 260 applies to the financial statements of entities: [260-10-15-2]

— whose common shares or potential common shares are traded in a public market – i.e. a domestic or foreign shares exchange or an over-the-counter market, including local and regional markets; or

— that file or are in the process of filing their financial statements with a securities commission or other regulatory authority for the purpose of selling common shares or potential common shares in a public market.

A common share is "stock that is subordinate to all other stock of the issuer." A potential common share is "a security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period." [260-10 Glossary]

This means instruments that can be exercised or converted into common shares (e.g. options, warrants, convertible securities, contingently issuable shares) are potential common shares. If such instruments are traded in a public market, the entity must present EPS on tf66he face of its performance (i.e. income) statement, even if it has no publicly traded common shares.

Question 2.2.10

When are shares 'traded in a public market'?

Interpretive response: Topic 260 does not define the term 'traded in a public market'. We believe determining whether shares are traded in a public market depends on the facts and circumstances and can vary based on local requirements from securities commissions and/or regulators. However, we believe that if the shares are traded in a public market (e.g. the NASDAQ or NYSE), they are publicly traded regardless of how often they are actually traded.

To determine whether a market in which shares are traded is a public market, an entity considers: [TQA 7100.03]

- whether the markets in which its shares are traded, listed or quoted are accessible to the public to execute trades; and
- whether those markets make various data publicly available, such as security listing, bid/ask pricing or trade data (price and volume).

Over-the-counter markets generally are not public markets if they are not accessible to the public or do not publish underlying financial information. However, we believe the OTC Pink Marketplace is a public market because the public has access to it and it publishes underlying financial information. Therefore, entities trading, listing or quoting securities on the OTC Pink Marketplace are in the scope of Topic 260.

In contrast, securities whose purchase is limited to specific investors are not considered accessible to the public, and therefore are not traded in a public market. For example, Rule 144A securities and many municipal securities issued in private placements can be sold only to qualified investors and therefore are not accessible to the public. [TQA 7100.14]

Question 2.2.20

When is an entity considered to be in the process of filing its financial statements with a securities commission or other regulatory authority?

Interpretive response: We believe that for an entity to be in the process of filing with a regulatory agency to sell shares in a public market, it needs to do more than simply plan on listing the shares. It has to have taken active steps to obtain a listing – e.g. preparing financial statements with the intention to include them in the filing or drafting a prospectus for the listing.

Question 2.2.30

If an entity's shares are not publicly traded at the reporting date, does Topic 260 apply if the shares are publicly traded when the financial statements are issued?

Interpretive response: If an entity does not meet the scope requirements of Topic 260 at the reporting date but its shares are publicly traded by the time the financial statements are issued (see paragraph 855-10-25-1A), the entity usually would have been in the process of filing its financial statements with a securities commission or other regulatory agency for this purpose at the reporting date. Accordingly, we believe the entity should disclose EPS information in those financial statements.

Question 2.2.40

When an entity's common shares or potential common shares trade for the first time during the current period, does the entity present EPS information prospectively only?

Interpretive response: No. An entity's common shares or potential common shares may be publicly traded for only a portion of the current period – e.g. because they were listed for the first time during the period. In this situation, we believe the entity presents EPS information for all periods for which an income statement is presented – not only for the periods during which the entity's common shares or potential common shares were publicly traded.

Further, SEC rules require that financial statements filed with the SEC include EPS on the face of the income statement for all periods presented. [S-X Rule 5-03(25)]

Question 2.2.50

Is a debt registrant required to present EPS information?

Interpretive response: No. The guidance in Topic 260 does not apply to an entity whose publicly traded securities comprise only traditional (i.e. not convertible) debt. [260-10-15-2]

Question 2.2.60

Is EPS information required in the financial statements of a private entity acquired by an entity that is required to present EPS information?

Interpretive response: No. An entity does not fall in the scope of Topic 260 by virtue of being a subsidiary of an entity that does apply Topic 260. Therefore, if an entity subject to Topic 260 acquires an entity that is not subject to Topic 260, the acquiree does not need to include EPS information in its audited historical financial statements when they are presented with the acquirer's financial statements. [260-10-15-3]

This is true even if the acquirer is an SEC registrant that must include those financial statements in a regulatory filing (i.e. under S-X Rule 3-05). However, an SEC registrant that is an acquirer in a business combination may need to present pro forma EPS for a business combination (see chapter 9).

Observation

Topic 260 scope vs Public Business Entity and other GAAP definitions

An entity that is in the scope of Topic 260 should not be confused with:

— the definition of a 'public business entity' (PBE), which includes a business entity that is required to file or furnish (or is a voluntary filer of) financial statements with the SEC; or

— other terms used by the FASB to denote an entity with publicly traded shares.

The FASB master glossary includes various terms referring to an entity with publicly traded shares (e.g. public entity, publicly traded entity) to depict how to determine if an entity is public. For purposes to applying Topic 260, only the guidance in Topic 260 (i.e. paragraph 260-10-15-2) is relevant.

Therefore, the guidance in Topic 260 does not change as a result of the PBE definition; some entities that are PBEs are not required to present EPS information in their financial statements.

Question 2.2.70

Is EPS information required in the consolidated financial statements of a parent that is not in the scope of Topic 260 but that has a subsidiary in scope?

Interpretive response: No. In some instances, the parent of a consolidated reporting entity does not meet the scope requirement in Topic 260, but its subsidiary does meet the scope requirement – e.g. a nonpublic parent owns a controlling interest in a publicly traded subsidiary. In this situation, the consolidated financial statements are not in the scope of Topic 260, but Topic 260 does apply to the subsidiary's stand-alone financial statements. [260-10-15-2]

Question 2.2.80

Can consolidated financial statements contain both consolidated EPS information and EPS information for individual entities in the consolidated group?

Interpretive response: No. An entity only presents EPS information for the consolidated entity. For example, for consolidated financial statements, EPS disclosures are required only on the basis of the consolidated information, and not for any individual financial statements that might be included. In addition, Topic 260 does not permit additional EPS information for individual entities to be presented on the face of the consolidated income statements. [260-10-45-5]

Question 2.2.90

Is an investment company required to present EPS information?

Interpretive response: No. Topic 260 does not apply to investment companies because they report under the requirements of Topic 946 (investment companies), and are out of scope of Topic 260. [260-10-15-3]

Question 2.2.100

If an entity has publicly traded shares that are not common shares or potential common shares, is it required to present EPS information?

Interpretive response: It depends. An entity's equity structure may not include common shares, and the entity may have an outstanding equity instrument that is not called a common share (or 'common stock') but is in essence a common share. This particularly applies to pass-through entities.

If an instrument enjoys rights that are similar to a common share (i.e. it participates in earnings similar to common shares, and does not have preferential rights), we believe it is considered a common share in applying Topic 260.

Shares may be called 'common' but contain a preference, and shares may be called 'preferred' but in essence have no preference and represent a different class of common shares. The name assigned to the entity's shares may not depict what the shares actually represent. Therefore, the terms and conditions of an entity's shares must be evaluated to determine whether they are common or preferred shares.

However, if the entity does not have any common shares because it does not identify a class of common shares that participates in earnings similar to common shares, then the entity is not required to present EPS information under Topic 260.

Question 2.2.102

If an entity presents EPS, is it presented for all classes of common stock, even if they are not all traded on a public market?

Interpretive response: Yes. An entity may have different classes of common stock – e.g. some may be publicly traded and others not. When an entity presents EPS, it presents EPS for all classes of stock that are considered common, regardless of whether they are traded on a public market, or whether they are termed 'common' (see Question 2.2.100). This is because the EPS calculation could be misleading, as it would exclude a group of shareholders that are determined to be the same as common shareholders with regard to rights and dividends.

Question 2.2.103

Is a limited partnership interest like common stock for purposes of presenting EPS?

Interpretive response: It depends. Topic 260 provides guidance for MLPs but is silent with regard to other partnerships. For limited partnership interests in the scope of Topic 260, we believe an entity should evaluate the substance of the interests – i.e. if the interests are like common stock or provides for a substantive preference, whether in dividends or in liquidation.

If the interests are like common stock, we believe the limited partnership is required to present EPS (if it is determined to be in the scope of Topic 260).

Question 2.2.105

Does Topic 260 apply to an entity in bankruptcy?

Interpretive response: Yes. An entity in bankruptcy applies Topic 260 and provides the additional disclosures required by Subtopic 852-10 (see section 9.2.10). See section 4.14 of KPMG Handbook, Accounting for bankruptcies. [852-10-45-16]

Master limited partnerships

Excerpt from ASC 260-10

05-2 The Master Limited Partnerships Subsections clarify the application of the General Subsection of the Other Presentation Matters Subtopic to master limited partnerships.

05-3 Publicly traded master limited partnerships often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical master limited partnership consists of publicly traded common units held by limited partners, a general partner interest, and incentive distribution rights. Depending on the structure of the master limited partnership, the incentive distribution rights may be a separate class of nonvoting limited partner interest that the general partner initially holds but generally may transfer or sell apart from its overall interest. Alternatively, the incentive distribution rights may be embedded in the general partner interest such that they cannot be detached and transferred apart from the general partner's overall interest.

05-4 Generally, the partnership agreement obligates the general partner to distribute 100 percent of the partnership's available cash (as defined in the partnership agreement) at the end of each reporting period to the general partner and limited partners via a distribution waterfall (that is, a schedule that prescribes distributions to the general partner and limited partners at each threshold) within a contractually determined period of time following the end of a reporting period. When certain thresholds are met, the distribution waterfall further allocates available cash to the holder of the separate class of nonvoting limited partner interest (the incentive distribution right holder) or, when the incentive distribution right is embedded in the general partner interest, to the general partner. The net income (or loss) of the partnership is allocated to the capital accounts of the general partner and limited partners based on their respective sharing of income or losses specified in the partnership agreement, but only after taking into account any priority income allocations resulting from incentive distributions.

> Overall Guidance

15-4 The Master Limited Partnership Subsections follow the same Scope and Scope Exceptions as outlined in the General Subsection of this Subtopic. See paragraphs 260-10-15-1 through 15-3, with specific qualifications noted in the following paragraph.

> Entities

15-5 A master limited partnership may issue incentive distribution rights that are a separate class of nonvoting limited partner interest that the general partner initially holds or incentive distribution rights that are embedded in the general partner interest and therefore cannot be detached or transferred apart from the general partner's overall interest. Incentive distribution rights that are a separate class of non-voting limited partner interest generally may be transferred or sold apart from the general partner interest. The Master Limited Partnership

Subsections apply to all master limited partnerships that meet both of the following criteria:

a. The partnership is required to make incentive distributions when certain thresholds have been met (regardless of whether the incentive distribution rights are a separate limited partner interest or embedded in the general partner interest)

b. The partnership accounts for the incentive distributions as equity distributions (as opposed to compensation costs).

The determination of whether the incentive distribution is an equity distribution or compensation cost is outside the scope of the Master Limited Partnership Subsection.

An MLP is a publicly traded partnership that offers the tax advantages of a partnership with the liquidity of a publicly traded entity. An MLP consists of a general partner (GP) who runs the business and limited partners (LPs) who are the investors. The GP receives compensation for services, and both the GP and LPs generally receive incentive distribution rights (IDRs) to share in the earnings of the MLP. IDRs are essentially the return on the partners' investments.

Topic 260 provides specific guidance for MLPs. Section 9.3 in this Handbook addresses EPS for MLPs.

Question 2.2.110

Does Topic 260 apply to all MLPs?

Interpretive response: No. The MLP subsections of Topic 260 apply only when an entity accounts for payments to IDR holders as equity distributions.

In our experience, predominant current practice is to account for distributions to partnership instruments that are equity in form (such as IDRs) as equity distributions (based in part on guidance in Subtopic 946-210-50). However, there may be instances in which all or a portion of those distributions represent compensation cost – e.g. if the IDRs are issued by a new MLP to the GP of a predecessor limited partnership to settle management contracts or for other services that will not carry over to the new MLP. IDR distributions accounted for as compensation cost are not considered participating securities to which the two-class method applies.

Question 2.2.120

Does Topic 260 apply if the IDRs are embedded in the LP interest?

Interpretive response: Yes. Topic 260 applies regardless of whether the IDRs are embedded in the LP interest or they trade separately (see section 9.3).

2.2.20 Classes of instruments for which EPS information is presented

EPS information is required only for common shares. Common shares participate in earnings for the period only after other types of claims (including preferred shares) have participated. Therefore, if a class of shares receives preference over another class of shares regarding earnings, it is not common shares. [260-10 Glossary]

If an entity has more than one class of common shares, EPS is disclosed for each class of common shares that has a different right to share in the earnings for the period. Therefore, it is important to first identify which of an entity's outstanding instruments are considered common shares and to then determine if there is more than one class of common shares. If an entity has shares with different rights, it considers whether all of the shares are in fact common shares.

Chapter 5 discusses in detail how to apply Topic 260 when there is more than one class of common shares. Specifically, it discusses the two-class method used to calculate EPS for each class of common shares (see section 5.3) and the two-class presentation method (see section 5.4). [260-10-45-59A – 45-60]

Example 2.2.10
Two classes of common shares

ABC Corp. has two classes of shares, X and Y.

- The holders of Class Y shares are entitled to dividends equal to 50% of any dividends declared on the Class X shares.
- Class Y shares are otherwise identical to Class X shares.
- Both classes are subordinate to all other classes of equity instruments with respect to participation in profit.

ABC concludes that both Class X and Class Y shares are common shares despite the difference in entitlement to dividends; this is because neither class is subordinate to the other. Separate EPS information is therefore required for both Class X and Class Y.

Observation
Multiple classes of common shares

An entity may have multiple classes of common shares even if only one is called 'common', if their terms are the same; see Question 2.2.100.

Further, multiple classes of common shares may exist when the liquidation and dividend rights are the same but, for example, a redemption feature exists, and some (but not all) shares are redeemable at other than fair value. See also Question 3.3.20.

Question 2.2.130

Is EPS information required for participating securities that are not considered a separate class of common shares?

Interpretive response: No. A participating security is one that participates in earnings together with common shares. An entity is not required to present separate EPS information for participating preferred shares (or any participating security) that is not considered to be a separate class of common shares. However, the entity would use the two-class method (see sections 5.2 and 5.3) to determine income available to common shareholders.

In addition, an entity may voluntarily present EPS information for participating securities. [260-10-45-60]

Example 2.2.20

Preferred shares that are not considered common shares

ABC Corp. has two classes of shares, X and Y.

- The holders of Class X shares are entitled to a fixed dividend per share.
- The holders of both Class X and Class Y shares have the right to participate equally in any additional dividends declared.

ABC concludes that Class X shares are not common shares because:

- the fixed entitlement creates a preference over the Class Y shares; and
- the Class Y shares are subordinate to the Class X shares.

The Class Y shares are the only class of common shares, and therefore the only class of shares for which EPS information is required. However, the participating rights of each class of shares, using the two-class method, should be used in determining income available to common shareholders (see section 5.3).

Question 2.2.140

How is tracking stock treated for EPS purposes?

Background: Tracking stock is a class of shares referenced to a specific business activity or entity. An entity may issue multiple classes of tracking stock with each class tied to a different business activity. Tracking stock represents an interest in the legal issuer that is based on the activities of the referenced business. The targeted business remains part of the issuer's consolidated group, is governed by the same board of directors, and may or may not be segregated in a separate subsidiary.

In most cases, the legal issuer of the tracking stock retains the ability to change terms and conditions related to the targeted stock and targeted business that will affect holders of the tracking stock and the reported operating results of the targeted business; this includes financing terms, cost allocations, asset and liability attributions, tax treatment and dividends. [2000 AICPA Conf]

Interpretive response: An entity with multiple classes of stock (i.e. tracking stock and common stock, or multiple classes of tracking stock) should use the two-class method to calculate earnings attributable to each class (see section 5.3).

The SEC staff has stated that presentation of EPS should be limited to the legal issuer's financial statements. If an entity presents separate financial statements for the business unit represented by the tracking stock, it does not show the tracking stock EPS information on the face of those separate financial statements (see also Question 2.2.80). The issuer determines EPS for each class of shares using the two-class method described in chapter 5. [2000 AICPA Conf]

2.2.30 Financial statement components for which EPS information is presented

Excerpt from ASC 260-10

> Required EPS Presentation on the Face of the Income Statement

45-2 Entities with simple capital structures, that is, those with only **common stock** outstanding, shall present basic per-share amounts for income from continuing operations and for net income on the face of the income statement. All other entities shall present basic and diluted per-share amounts for income from continuing operations and for net income on the face of the income statement with equal prominence.

45-3 An entity that reports a discontinued operation in a period shall present basic and diluted per-share amounts for that line item either on the face of the income statement or in the notes to the financial statements.

If an entity has only common shares outstanding (meaning no potential common shares outstanding), it presents only basic EPS (see chapter 3). However, if it has both common shares and potential common shares outstanding, it presents both basic EPS and diluted EPS when the potential common shares are dilutive (see chapter 4).

Basic and diluted EPS for both continuing operations and net income are presented on the face of the income statement with equal prominence for all periods. [260-10-45-2]

Certain other per share information may also be presented (see section 9.2).

2.3 Voluntary presentation of EPS information

An entity that would not otherwise be required to present EPS information (see section 2.2.10) may wish to present basic and diluted EPS. If an entity voluntarily presents EPS information, that information is calculated and presented under Topic 260. Therefore, all of the applicable requirements set out in Topic 260 apply. [260-10-15-3]

Further, we believe the SEC staff guidance relating to EPS should be applied by all entities presenting EPS, even if presenting EPS voluntarily.

2.4 Types of EPS information presented

Topic 260 requires the presentation of two types of per share measures, if applicable.

— **Basic EPS** is presented when an entity has common shares outstanding. Basic EPS is income for the period divided by the common shares outstanding for EPS purposes (see chapter 3).

— **Diluted EPS** is presented when an entity has both common shares and dilutive potential common shares outstanding. Diluted EPS is basic EPS adjusted for the theoretical effect of the conversion or exercise of potential common shares outstanding (see chapter 4).

3. Basic EPS – The foundations

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

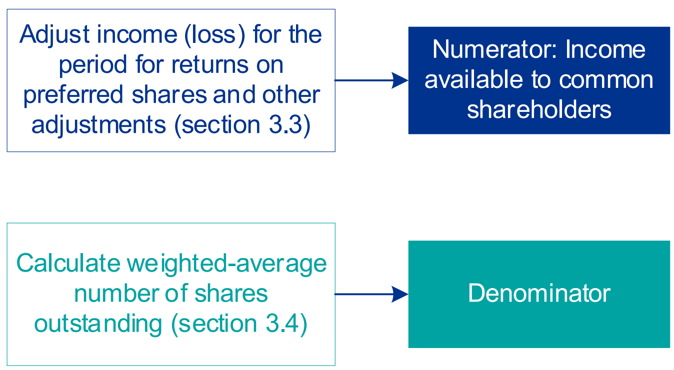
3.1 How the standard works

Basic EPS is calculated as a ratio. We use the following three-step approach in this Handbook to calculate this ratio and determine basic EPS.

Three-step approach to basic EPS

1. Determine the income available to common shareholders for the reporting period (the numerator) (section 3.3)
2. Determine the weighted-average number of outstanding common shares for the reporting period (the denominator) (section 3.4)
3. Determine basic EPS (section 3.5)

The following diagram illustrates the calculation of this ratio.



3.2 Overview

Excerpt from ASC 260-10

> Basic EPS

10-1 The objective of basic earnings per share (EPS) is to measure the performance of an entity over the reporting period.

• > Computation of Basic EPS

45-10 Basic EPS shall be computed by dividing **income available to common stockholders** (the numerator) by the **weighted-average number of common shares outstanding** (the denominator) during the period. Shares issued during the period and shares reacquired during the period shall be weighted for the portion of the period that they were outstanding. See Example 1 (paragraph 260-10-55-38) for an illustration of this guidance.

Basic EPS aims to provide a measure of the interest of each common share in the performance of the entity over a reporting period.

Simply put, basic EPS is an entity's income or loss that is available to common shareholders for a reporting period (the numerator) divided by the weighted-average number of outstanding common shares during the reporting period (the denominator).

Income available to common shareholders	÷	Weighted-average number of outstanding common shares during the reporting period	=	Basic EPS

Example 3.2.10
Basic EPS calculation

ABC Corp. has a simple capital structure comprising 3,000,000 common shares outstanding during the entire year. ABC's income available to common shareholders for Year 1 is $4,600,000.

Basic EPS calculation – Year 1

Basic EPS

1 Determine the numerator

Income available to common shareholders is $4,600,000.

2 Determine the denominator

Weighted-average number of common shares outstanding during the year is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

If an entity reports discontinued operations, it presents separate EPS information for continuing operations, discontinued operations and net income (loss).

In practice, the basic EPS calculation may be more complex than Example 3.2.10 and adjustments may be required to the numerator and denominator. The rest of this Handbook approaches the basic EPS calculation following this three-step approach illustrated in the above example but using more complex fact patterns.

3.3 Step 1: Determine the numerator

3.3.10 Which earnings to use?

Excerpt from ASC 260-10

• > Income Available to Common Stockholders and Preferred Dividends

45-11 Income available to common stockholders shall be computed by deducting both the dividends declared in the period on **preferred stock** (whether or not paid) and the dividends accumulated for the period on cumulative preferred stock (whether or not earned) from income from continuing operations (if that amount appears in the income statement) and also from net income. If there is a loss from continuing operations or a net loss, the amount of the loss shall be increased by those preferred dividends. An adjustment to net income or loss for preferred stock dividends is required for all preferred stock dividends, regardless of the form of payment. Preferred dividends that are cumulative only if earned shall be deducted only to the extent that they are earned.

The numerator for the basic EPS calculation is the income available to common shareholders of an entity; this is not necessarily the same as income on the income statement. As such, an entity's income (loss) is adjusted for returns to other classes of equity instruments (such as preferred shares and other participating securities) that have not already been deducted in arriving at income (loss). In contrast, income (loss) is not adjusted for the returns to (and other income effects of) liability-classified preferred shares because these amounts are already deducted from income (loss).

	Income (loss), adjusted for:	
Step 1: Determine the numerator	Returns on equity-classified preferred shares	Sections 3.3.20 – 3.3.60
	Returns on participating equity instruments and other classes of common shares	Section 3.3.70
	Obligation to cover NCI losses	Section 3.3.80

The discussion that follows in sections 3.3.20 to 3.3.60 refers to adjustments to 'income available to common shareholders' for dividends, but applies equally when that income may be a loss – i.e. dividends should be deducted whether there is income or loss available to common shareholders.

Question 3.3.05

Which income is used to calculate income available to common shareholders?

Interpretive response: Income available to common shareholders is calculated from income from continuing operations. For an entity that does not have discontinued operations, income from continuing operations is the same as net income.

When there are discontinued operations, EPS for net income is calculated as EPS from continuing operations less the effect of discontinued operations. Adjustments are made to income from continuing operations and are not made again to net income to avoid double-counting the adjustments. [260-10-45-11]

3.3.20 Returns on equity-classified preferred shares

Excerpt from ASC 260-10

• > Income Available to Common Stockholders and Preferred Dividends

45-12 Preferred stock dividends that an issuer has paid or intends to pay in its own common shares shall be deducted from net income (or added to the amount of a net loss) in computing income available to common stockholders. In certain cases, the dividends may be payable in common shares or cash at the issuer's option. The adjustment to net income (or net loss) for preferred stock dividends payable in common stock in computing income available to common stockholders is consistent with the treatment of common stock issued for goods or services.

Returns on equity-classified preferred shares (i.e. dividends, including deemed dividends) are not included in income (loss) for a period. Accordingly, the numerator for the basic EPS calculation needs to be adjusted for these returns so that it reflects only the income available to common shareholders. [260-10-45-11 – 45-12]

Returns on equity-classified preferred shares	
	Dividends on *noncumulative* preferred shares declared in the period (section 3.3.30)
+	Dividends on cumulative preferred shares earned during the period, whether declared or not (sections 3.3.30 and 3.3.60)
+/–	Any original issue discount (premium) on increasing-rate preferred shares (section 3.3.40)
+/–	Any differences on settlement (section 3.3.50)

Question 3.3.10

Is income adjusted when a preferred dividend is paid in shares, similar to dividends paid in cash?

Interpretive response: Yes. Dividends on preferred shares (including deemed dividends, as discussed throughout this section) are adjustments when calculating income available to common shareholders, regardless of whether they are paid in cash or shares or any other form (i.e. paid in kind). Therefore, when an entity pays a preferred dividend in shares, such dividend is also subtracted from income available to common shareholders. [260-10-45-11 – 45-12]

Question 3.3.15

Is income adjusted for cumulative dividends that are not recorded?

Interpretive response: Yes, because the dividends are cumulative. The adjustment for cumulative preferred dividends is made regardless of whether the dividend is recorded. Cumulative dividends on equity-classified stock that are earned, but not declared, are not recorded on the balance sheet, for example, for cumulative perpetual preferred stock. However, income available to common shareholders is adjusted for these dividends (see section 3.3.30 and Question 3.3.32). [260-10-45-11]

Question 3.3.20

How do instruments classified in temporary equity affect EPS?

Background: SEC guidance requires an equity instrument with a redemption feature that is not solely within the control of the issuer to be classified outside of permanent equity – often referred to as classification in temporary or mezzanine equity. This classification guidance applies to SEC registrants, but other entities may apply it voluntarily as a policy election. [480-10-S99-3A]

Interpretive response: Adjustments to the carrying amount of redeemable instruments that are classified as temporary equity will not affect net income or comprehensive income, but may affect the EPS calculation; this is because the redemption is treated like the repurchase of shares (see Question 3.3.120). Treatment for EPS purposes will vary depending on the instrument and on whether the redemption provision is at fair value. [480-10-S99-3A]

Redeemable common shares

If an entity has issued redeemable common shares that are classified as temporary equity, this classification does not preclude the shares from being included in the calculation of basic EPS (and diluted EPS – see chapter 4). This is because the shares are not mandatorily redeemable and, therefore are considered outstanding unless they are redeemed.

Generally, the number of common shares representative of the common shares classified in temporary equity should be included in the weighted-average number of common shares outstanding (the denominator). However, the effect on EPS depends on whether the common shares are redeemable at fair value.

— **Redeemable at fair value.** The common shares are included in the denominator of the EPS calculation reflecting a single class of common shares. This is because the redemption feature for all of the common shares is at fair value, and therefore it does not create a different class of shares or other EPS adjustment (i.e. no adjustment to the numerator). The redemption at fair value does not represent an economic benefit to the holders that is different from what is received by other shareholders, because the shares could be sold on the open market.

— **Redeemable at other than fair value.** These common shares include an in-substance preferential distribution when the redemption amount is greater than fair value. Increases or decreases in the carrying amount of the redeemable instrument are reflected in the EPS calculation using the two-class method. The redeemable common shares are included in the denominator of the EPS calculation as a separate class of common shares (see section 5.2 and Question 5.3.40).

According to SEC guidance, common stock that is redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to equal or reasonably approximate fair value. The SEC staff believes that a formula based solely on a fixed multiple of earnings (or other similar measure) is not designed to equal or reasonably approximate fair value. [480-10-S99-3A FN 18]

Other redeemable instruments in temporary equity, other than common stock and NCI

The effect on EPS of other redeemable instruments is similar for those redeemable at fair value and at other than fair value.

Any increases or decreases in the carrying amount of these securities is charged against retained earnings; or in the absence of retained earnings, against additional paid-in-capital. Such increases or decreases are treated like dividends on nonredeemable preferred shares and also reduce or increase income available to common shareholders in calculating EPS. This may result in a reversal of prior year increases, and a negative deemed dividend. However, these redeemable preferred shares cannot be reduced below their initial carrying amounts in temporary equity – i.e. the adjustment in calculating EPS is limited by the initial carrying amount.

See also Question 3.3.30.

Question 3.3.22

How do contingently redeemable instruments affect basic EPS?

Interpretive response: Contingently redeemable instruments do not affect basic EPS until it is probable that the contingency will be met. Once it is probable that the contingency will be met, the instrument is remeasured, and its EPS effect depends on whether the instrument is liability- or equity-classified. These effects are discussed in Questions 3.3.20 and 3.3.30.

Question 3.3.30

How do mandatorily redeemable shares or certain forward contracts classified as a liability affect income available to common shareholders?

Interpretive response: An entity should distinguish redeemable shares classified in temporary equity (see Question 3.3.20) from mandatorily redeemable preferred shares classified as a liability under Topic 480 (liabilities versus equity). Mandatorily redeemable preferred shares that are liability-classified are redeemed for cash, and therefore they do not affect the EPS denominator (see section 3.4).

The EPS numerator effects of liability-classified instruments vary by instrument.

— **Mandatorily redeemable preferred shares.** Dividends and other adjustments to the carrying amount of mandatorily redeemable preferred shares classified as a liability are recognized in earnings as interest expense. Therefore, no additional adjustment is required in the numerator of the EPS calculation to arrive at income available to common shareholders unless those shares are entitled to participate in distributions to common shareholders as described in section 6.14.20.

— **Other instruments.** Entities that have issued mandatorily redeemable shares of common stock or entered into forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares of common stock in exchange for cash have no numerator adjustment for dividends on these common stock instruments, but exclude the common shares that are to be redeemed or repurchased in calculating basic (and diluted – see chapter 4) EPS (see section 3.4.30). See also section 6.15.

Any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to shares that are to be redeemed or repurchased that have *not* been recognized as interest expense under paragraphs 480-10-35-3 and 480-10-45-3, are deducted in calculating income available to common shareholders, using the two-class method (see section 5.3).

3.3.30 Preferred dividends – cumulative vs noncumulative

Dividends on equity-classified preferred shares may be cumulative or noncumulative. Preferred dividends are cumulative if any dividend entitlements that are not paid or declared with respect to a particular period accrue and are carried forward. Preferred dividends are noncumulative when dividend entitlement lapses if the dividends are not declared; the preferred dividends for the lapsed period are not added to future dividend payments or other returns in this instance.

Cumulative dividends

If the dividends are cumulative, the preferred dividends for the current period are deducted from income or added to a loss in calculating income available to common shareholders, regardless of whether they are declared. However, in some cases dividends are cumulative only if earned. In that case, preferred dividends are deducted from the numerator only if they have been previously earned in the period. [260-10-45-11]

Noncumulative dividends

In contrast, dividends on noncumulative preferred shares are not deducted in arriving at the numerator unless they have been declared by the reporting date. The numerator should not be adjusted for noncumulative dividends declared after the reporting date, even if these dividends relate to the reporting period. This is consistent with Topic 855 (subsequent events), because the declaration of dividends is a nonrecognized subsequent event given that no obligation exists at the reporting date. [260-10-45-11]

Although noncumulative preferred dividends are generally ignored in the numerator of the basic EPS calculation unless they are declared during the reporting period, separate considerations apply to the allocation of earnings if the preferred shares participate in dividends with common shares as participating securities (see chapter 5).

Further, if a noncumulative preferred share is remeasured under paragraph 480-10-S99-3A, this may result in a deemed dividend or deemed contribution; any such amount is an adjustment to income available to common shareholders. See Question 3.3.20.

The examples that follow contrast the treatment of cumulative and noncumulative preferred dividends in the numerator of the basic EPS calculation.

Question 3.3.32

Are dividends declared on equity-classified instruments always deducted from income available to common shareholders during the period declared?

Interpretive response: No. The treatment of declared dividends for EPS purposes depends on whether the dividends are cumulative.

When noncumulative dividends are declared, they are deducted from income available to common shareholders in the period declared. However, cumulative dividends are reflected in EPS as they accrue, i.e. they are deducted from income available to common shareholders whether or not declared. Therefore, the period in which dividends are deducted from income available to common shareholders may not necessarily be the same period in which they are declared. Adjusting for the dividends as they accrue and then also in a later period when declared would result in double counting the dividends; therefore, the cumulative dividends are only deducted from income available to common shareholders as they accrue. [260-10-45-11]

Question 3.3.34

What is meant by dividends that are 'earned'?

Background: Paragraph 260-10-45-11 provides that dividends accumulated for a period on cumulative preferred stock (*whether or not earned*) are deducted to arrive at income available to common shareholders. It also provides that preferred dividends that are *cumulative only if earned*, are deducted from income available to common shareholders *only when earned*. [260-10-45-11]

Interpretive response: We believe 'preferred dividends that are cumulative only if earned' are those that are cumulative only upon the occurrence of an event outside the control of management, and therefore there is a contingency associated with those preferred dividends. We believe such dividends are considered cumulative, for purposes of adjusting income available to common shareholders, only when the contingent event occurs (i.e. the contingency is resolved).

For example, if the terms provide for a 5% cumulative preferred dividend when earnings exceed a specified threshold, those dividends are deducted from income available to common shareholders only if earnings for the period exceed that target.

Conversely, cumulative preferred dividends that are contingent upon an event not occurring, are considered earned in that period so long as the event did not occur during the period.

Question 3.3.35

Do dividends on a liability-classified instrument result in an adjustment to income available to common shareholders?

Interpretive response: No. Dividends on liability-classified instruments (e.g. mandatorily redeemable preferred shares) are not included as an adjustment to income available to common shareholders. Since dividends on a liability-classified instrument are already charged against earnings as interest costs, making a numerator adjustment for those dividends would be double-counting them (i.e. reducing from income twice). See KPMG Handbook, Debt and equity financing, Question 6.9.30 for further guidance on interest costs (which include any amount paid or to be paid to holders in excess of the initial measurement amount).

Example 3.3.10

Cumulative preferred dividends – numerator adjustment

ABC Corp. has 500,000 equity-classified preferred shares outstanding throughout the year.

- Each preferred share is entitled to a cumulative dividend of $1.20, but has no further rights to participate in dividends with common shares.
- Net income for Year 1 is $4,600,000.

Basic EPS numerator calculation – Year 1

Basic EPS

1 Determine the numerator

The numerator of the basic EPS calculation is the income available to ABC's common shareholders for the period. To determine this amount, ABC reduces its net income by returns to which the holders of the equity-classified preferred shares are entitled. These returns are deducted from net income regardless of whether preferred dividends are declared or paid during the year because the dividends are cumulative.

Net income	$4,600,000
Preferred dividends [500,000 × $1.20]	(600,000)
Income available to common shareholders	**$4,000,000**

Accordingly, the numerator is $4,000,000.

Example 3.3.20
Noncumulative preferred dividends – potential numerator adjustment

Assume the same facts as in Example 3.3.10, except that the preferred dividends are noncumulative. The following additional facts are relevant.

- Scenario 1: ABC declares and authorizes dividends before the reporting date.
- Scenario 2: ABC declares and authorizes dividends for the year after the reporting date but before its financial statements are issued (available to be issued).
- Scenario 3: ABC declares and authorizes dividends for Year 1 after its financial statements are issued (available to be issued).

Basic EPS numerator calculation – Year 1

Basic EPS

1 Determine the numerator

The numerator of the basic EPS calculation is the income available to ABC's common shareholders for the period. Income available to common shareholders is determined by reducing net income by any noncumulative dividends declared and authorized before the reporting date. Noncumulative dividends declared and authorized after the reporting date are not deducted from net income.

	Scenario 1	Scenario 2	Scenario 3
Net income	$4,600,000	$4,600,000	$4,600,000
Noncumulative preferred dividends [500,000 × $1.20]	(600,000)	–[1]	–
Income available to common shareholders	**$4,000,000**	**$4,600,000**	**$4,600,000**

Note:

1. Disclosure of the dividend under Topic 855 is applicable.

Question 3.3.36

How does a liquidation preference affect income available to common shareholders?

Interpretive response: A liquidation preference is a preferential right to a distribution upon liquidation. This does not affect income available to common shareholders until the liquidation event occurs, similar to contingent dividends that are not deducted until the contingency occurs. See Question 3.3.34.

Question 3.3.38

Is a change in liquidation preference of preferred shares considered a dividend and deducted from income available to common shareholders?

Interpretive response: Generally, no. A change in the liquidation preference of preferred shares itself – one that only affects the liquidation preference and only takes effect upon a liquidation – does not affect income available to common shareholders.

However, income available to common shareholders is affected if there is also a change that results in a deemed dividend for accounting purposes (e.g. as part of a modification).

3.3.40 Original issue discount on increasing-rate preferred shares

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Increasing-rate preferred shares are a type of preferred share where the coupon rate is usually zero or a lower rate in the initial years and increases over time to a higher permanent rate. Because of their lower initial coupon rate, increasing-rate preferred shares generally are issued at a discount. The discount is based on the price for which the preferred shares would have sold had the permanent dividend rate been in effect at issuance. As a result, the discount represents a prepaid, unstated dividend cost.

Question 3.3.40

How do increasing-rate preferred shares affect income available to common shares?

Interpretive response: SEC guidance requires the discount to be amortized through a charge to retained earnings and a corresponding increase in the carrying amount of the preferred shares using the effective interest rate inherent in the shares (rather than the nominal dividend schedule for the shares) to reflect a constant rate of return for the shares. [505-10-S99-7]

An entity should treat those periodic increases like a dividend on nonredeemable preferred shares for EPS calculations – i.e. as a reduction in income available to common shareholders. [505-10-S99-7]

Example 3.3.30
Original issue discount on increasing-rate preferred shares

On January 1, Year 1, ABC Corp. issues 10,000 nonredeemable cumulative preferred shares with a par value of $100 each.

— Each share is entitled to a cumulative dividend of $7 each year, starting from Year 4, paid in arrears.

— At the time of issuance, the market yield on instruments with similar terms is 7% per annum.

— Each share is issued for $81.63, producing a discount of $18.37. This discount compensates for the below-market dividend yield in the first three years.

— Net income for Year 1 is $400,000.

ABC classifies the preferred shares as equity instruments and amortizes the original issue discount to retained earnings using the effective interest method.

Basic EPS numerator calculation – Year 1

The annual amortization of the original issue discount on ABC's increasing-rate preferred shares in the first three years is treated as a preferred dividend when determining the numerator.

	Year 1	Year 2	Year 3	Year 4 onward
Carrying amount of one preferred share at January 1	$81.63	$87.34	$93.46	$100.00
Imputed dividend at 7% (amortization of original issue discount), recognized directly in equity[1]	5.71	6.12	6.54	7.00
Dividend paid	–	–	–	(7.00)
Carrying amount of one preferred share at December 31	**$87.34**	**$93.46**	**$100.00**	**$100.00**

Note:

1. Year 4 onward reflects a cumulative dividend.

Assuming this is the only necessary adjustment, the numerator for basic EPS in Year 1 is determined as follows.

Basic EPS

1 Determine the numerator

The imputed dividend on the preferred shares in Year 1 is deducted from net income to determine the income available to common shareholders.

Net income	$400,000
Imputed dividend on preferred shares [10,000 × $5.71]	(57,100)
Income available to common shareholders	**$342,900**

Accordingly, the numerator is $342,900.

3.3.50 Differences on settlement of equity-classified preferred shares

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• • > SEC Staff Announcement: The Effect on the Calculation of Earnings Per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock

S99-2 The following is the text of SEC Staff Announcement: The Effect on Calculation of Earnings Per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock.

Scope

This SEC staff announcement applies to redemptions and induced conversions of equity-classified preferred stock instruments. For purposes of this announcement:

1. Modifications and exchanges of preferred stock instruments that are accounted for as extinguishments, resulting in a new basis of accounting for the modified or exchanged preferred stock instrument, are considered redemptions.
2. A preferred stock instrument classified within temporary equity pursuant to the guidance in ASR 268 and paragraph 480-10-S99-3A is considered equity-classified, and redemptions and induced conversions of such securities would be subject to this guidance.
3. If an equity-classified security is subsequently required to be reclassified as a liability based on the provisions of other GAAP (for example, because a preferred share becomes mandatorily redeemable pursuant to Subtopic 480-10), the reclassification is considered a redemption of equity by issuance of a debt instrument.

The accounting for conversions of preferred stock instruments into other equity-classified securities pursuant to conversion privileges provided in the terms of the instruments at issuance is not affected by this announcement.

The Effect on Income Available to Common Stockholders of a Redemption or Induced Conversion of Preferred Stock

If a registrant redeems its preferred stock, the SEC staff believes that the difference between (1) the fair value of the consideration transferred to the holders of the preferred stock and (2) the carrying amount of the preferred stock in the registrant's balance sheet (net of issuance costs) should be subtracted from (or added to) net income to arrive at income available to common stockholders in the calculation of earnings per share. The SEC staff believes that the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the preferred stock in the registrant's balance sheet represents a return to (from) the preferred stockholder that should be treated in a manner similar to the treatment of dividends paid on preferred stock. This calculation guidance applies to redemptions of convertible preferred stock regardless of whether the embedded conversion feature is "in-the-money" or "out-of-the-money" at the time of redemption...

If convertible preferred stock is converted into other securities issued by the registrant pursuant to an inducement offer, the SEC staff believes that the excess of (1) the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over (2) the fair value of securities issuable pursuant to the original conversion terms should be subtracted from net income to arrive at income available to common stockholders in the calculation of earnings per share. Registrants should consider the guidance provided in Subtopic 470-20 to determine whether the conversion of preferred stock is pursuant to an inducement offer.

Equity-classified preferred shares may be repurchased, redeemed or converted. Any differences on settlement – e.g. an excess of the fair value of the consideration paid over the carrying amount of the preferred shares – represent a return to the holders of the preferred shares that is not recognized in earnings. Accordingly, the numerator is adjusted for any differences on the settlement of equity-classified preferred shares. The numerator is also adjusted for 'other similar effects' of equity-classified preferred shares.

The guidance that follows relates to both equity-classified preferred shares, as well as preferred shares classified as temporary equity under paragraph 480-10-S99-3A.

Redeeming preferred shares

Redeeming preferred shares also results in an adjustment to income available to common shareholders if the amounts paid to settle the shares differ from their carrying amount before redemption. An entity deducts all amounts paid on redemption of the shares over their carrying amount (regardless of redemption rights) to determine income available to common shareholders for EPS calculations.

The SEC staff believes this amount represents a return to the preferred shareholders; therefore, an entity should treat it in a manner similar to dividends paid (i.e. a deemed dividend) to the preferred shareholders in its EPS calculation. An entity adds any excess of the carrying amount of preferred shares over the fair value of the consideration transferred to preferred shareholders to net income to determine net income available to common shareholders (i.e. a deemed contribution). An entity may disclose those amounts separately or combined with dividends and accretion, including on a per share basis. Also, any accumulated but unpaid preferred dividends already deducted from income available to common shareholders are added to the carrying amount of the preferred shares in the calculation, to prevent double counting the dividend – assuming the value of the preferred dividend is reflected in the fair value of the consideration transferred. [260-10-S99-2]

We believe this SEC guidance should be applied by all entities that present EPS.

Example 3.3.40
Redeeming convertible preferred shares

Year 1 issuance

On January 1, Year 1, ABC Corp. issues 1,000 convertible preferred shares for their par amount of $1,000 per share and issuance costs of $100,000 ($900,000 net proceeds).

- The preferred shares are redeemable by ABC (but not mandatorily redeemable) and there are no embedded put options that could allow the holder to require ABC to redeem the shares.
- Each share is immediately convertible into 100 common shares (i.e. $10 effective conversion price).
- Neither the redemption option nor the conversion option is required to be separately accounted for as a derivative.

ABC records the following journal entry when the shares are issued.

	Debit	*Credit*
Cash	900,000	
Preferred shares – discount	100,000	
Preferred shares		1,000,000
To record issuance of preferred shares and related issuance costs.		

Year 2 redemption

In Year 2, ABC redeems all of the convertible preferred shares for $1,850 cash per share (total consideration of $1,850,000).

Net income for Year 2 is $5,000,000.

ABC records the redemption in the following journal entry.

	Debit	Credit
Preferred shares	1,000,000	
Retained earnings	950,000	
Preferred shares – discount		100,000
Cash		1,850,000
To record redemption of preferred shares.		

Basic EPS numerator calculation – Year 2

Assuming this is the only instrument with a necessary adjustment, the numerator for basic EPS in Year 2 is calculated as follows.

Basic EPS

1 Determine the numerator

The excess of the consideration paid to preferred shareholders over the preferred shares' carrying amount is deducted from net income to determine the income available to common shareholders.

Net income	$5,000,000
Excess of consideration paid to preferred shareholders over preferred shares carrying amount (net of issuance costs) [$1,850,000 – ($1,000,000 – $100,000)]	(950,000)
Income available to common shareholders	**$4,050,000**

Accordingly, the numerator is $4,050,000.

Question 3.3.60

Does the SEC guidance on redemptions and induced conversions of preferred shares apply to other types of preferred share transactions?

Interpretive response: Yes. The SEC guidance specifically includes redemptions of preferred shares and induced conversions of preferred shares, although 260-10-S99-2 can also be applied to other preferred share transactions.

According to the SEC staff, the following situations are considered redemptions and the 260-10-S99-2 guidance applies. [260-10-S99-2]

— An equity-classified preferred share instrument is modified or exchanged, and there is a new basis of accounting for the instrument – e.g. the transaction is accounted for as an extinguishment.

— An equity-classified (including those that are temporary-equity) preferred share is reclassified as a liability – e.g. if it becomes mandatorily redeemable, such as when a condition for redemption is resolved.

When preferred shares are classified as a liability, the 260-10-S99-2 guidance is not applied when those preferred shares are modified, exchanged or converted. [260-10-S99-2]

However, when the guidance in paragraph 260-10-S99-2 does not apply, amounts may be recognized as deemed dividends under other accounting guidance, also resulting in an adjustment to income available to common shareholders. This may occur when:

— an equity-classified preferred share is modified or exchanged, and modification accounting is applied, and the incremental value obtained therefrom results in incremental value to the preferred shareholder resulting in a deemed dividend; or

— an equity-classified preferred share is converted according to the stated conversion privileges (i.e. is not an induced conversion) and unamortized discounts are reflected as a deemed dividend upon conversion.

Question 3.3.90 discusses instruments other than preferred shares and the applicability of paragraph 260-10-S99-2 to related transactions.

Inducement for early conversion of preferred shares

An example of an 'other similar effect' to differences on the settlement of equity-classified preferred shares is an inducement for early conversion of equity-classified convertible preferred shares, either by favorably amending the original conversion terms or by paying additional consideration to the preferred shareholders. Similar to differences on settlement, such an inducement is not recognized in earnings but nevertheless represents a return to preferred shareholders for which the numerator is adjusted. [260-10-S99-2]

Question 3.3.80

If the fair value of common shares paid in an early conversion of preferred shares exceeds the fair value of common shares issuable under the original conversion terms, how does the excess affect EPS?

Interpretive response: The SEC believes that if the fair value of the common shares or other consideration paid exceeds the fair value of the common shares issuable under the original conversion terms (e.g. in an inducement offer), this excess is a return to preferred shareholders and is deducted from net income (or loss) in arriving at the numerator for basic EPS. [260-10-S99-2]

Fair value of all securities and other consideration transferred in the transaction by the registrant to the convertible preferred shareholders	−	Fair value of securities issuable according to the original conversion terms	=	**Adjustment to income available to common shareholders**

This guidance applies only to induced conversions, and not to conversions effected pursuant to the original terms of the instrument (see Question 3.3.110). Subtopic 470-20 (debt with conversion and other options) contains guidance on determining if a conversion is pursuant to an inducement offer. [260-10-S99-2]

Observation
Redemption vs inducement

A redemption may result in a deemed dividend or a deemed contribution, depending on whether the adjustment to an instrument's carrying amount upon redemption is an increase or decrease.

In contrast, an inducement will always result in a deemed dividend, even if the conversion, after the offer, is out-of-the-money. This is because in an inducement, SEC guidance requires comparing the *fair values* of the instruments (1) that (would have been received under the original agreement and (2) under the inducement offer – and the fair value for the inducement will always have a value that is greater. [260-10-S99-2]

Question 3.3.85
At what point is the EPS effect of an inducement offer recognized?

Interpretive response: We believe an inducement is reflected in EPS when it is accepted by the holder, which is the earlier of when the holder of the instrument agrees to the offer or converts. An inducement offer being made, in and of itself, does not trigger EPS implications.

Example 3.3.60
Inducement for early conversion

Year 1 issuance

On January 1, Year 1, ABC Corp. issues convertible preferred shares with a par value of $1,000,000.

The preferred shares are:

— entitled to a dividend of $10 per share each year (noncumulative); and
— convertible at the holders' option into 500,000 common shares.

ABC classifies the preferred shares as equity instruments.

Year 2 conversion

During Year 2, in light of changes in market yields, ABC wishes to induce early conversion of the preferred shares. To achieve this, ABC agrees with the preferred shareholders to modify the conversion terms such that the preferred shares are convertible into 600,000 common shares – i.e. 100,000 additional common shares will be issued on a full conversion.

- All of the preferred shares are converted into common shares on June 30, Year 2, when the market price per common share is $2.50.
- No dividends are declared for Year 2.
- Net income for Year 2 is $1,000,000.

Basic EPS numerator calculation – Year 2

Basic EPS

1 **Determine the numerator**

The excess of the fair value of the consideration paid to preferred shareholders over the fair value of the common shares issuable under the original conversion terms is deducted from net income to determine the income available to common shareholders.

Net income	$1,000,000
Excess of the fair value of the consideration paid to preferred shareholders over the fair value of the common shares issuable under the original conversion terms [100,000 × $2.50]	(250,000)
Income available to common shareholders	**$750,000**

Accordingly, the numerator is $750,000.

Question 3.3.90

Does the guidance on inducement for the early conversion of shares apply to instruments other than preferred shares?

Background: To raise capital in a prior period, ABC Corp. sold warrants to purchase its common shares to outside nonemployee investors for cash. The investors have no other relationship with ABC. To induce exercise of the outstanding warrants, ABC reduces the exercise price of the warrants for a 60-day period.

Interpretive response: No. We believe the SEC guidance on inducements for the early conversion of preferred shares in paragraph 260-10-S99-2 applies only to classes of equity securities other than common shares.

In the background facts, the reduction in the exercise price of the warrants is a modification explicitly addressed in Topic 260. See sections 3.3.60 and 6.18. [260-20-25-1, 30-1, 35-1]

However, if the instruments are participating securities (see section 5.2), we believe an entity should analogize to the guidance on inducements of preferred securities and subtract the difference in fair value from income available to common shareholders. [260-10-S99-2]

Further, if the instruments are held by employees, the reduction in exercise price is generally considered compensation expense. [718-20-35-5]

Exchange or modification of preferred shares

Question 3.3.100

How does the exchange of preferred shares for other preferred shares affect EPS?

Interpretive response: The SEC staff believes that when a registrant exchanges a preferred share instrument for another preferred share instrument (e.g. the terms change), the registrant must first determine whether that exchange is an extinguishment or a modification. [2014 AICPA Conf]

If the exchange is considered an extinguishment, the registrant treats the extinguishment for EPS purposes as if it had redeemed the original preferred share. See Redeeming preferred shares earlier in this section. [260-10-S99-2]

If the exchange is considered a modification, the registrant may be required to record an expense (e.g. compensation expense) or an EPS effect (i.e. deemed dividend) depending on the circumstances. Also, we believe any costs paid to investors in connection with the modification that were recorded in retained earnings are also treated as a deemed dividend when calculating EPS. [2014 AICPA Conf]

We believe this guidance should be applied by all entities. See also Questions 3.3.60 and 3.3.105.

Question 3.3.105

Does the modification or exchange of preferred shares for little or no incremental transfer of value affect EPS?

Background: Some modifications or exchanges of preferred shares involve little to no incremental transfer of value to the common shareholders. This occurs most commonly when existing preferred shares are modified or exchanged at the same time that a new series of preferred shares is issued. The modification might encompass concessions or accepting a declined value by the existing preferred shareholders to attract new investors.

Interpretive response: A modification or exchange of preferred shares for little or no consideration requires careful evaluation of the facts and circumstances of the preferred share transaction, including determining the fair value of the common shares before and after the transaction. Sometimes there is no value transferred to or from the common shareholders as part of the modification or exchange, and, therefore, no accounting entry is required for the modified or exchanged preferred stock.

When an entity's existing preferred shares have been modified or exchanged, we believe the entity should:

1. perform the evaluation of whether an incremental transfer of value has occurred to or from the common shareholders as a result of the preferred stock modification or exchange; then
2. consider whether it constitutes a modification or extinguishment as discussed in Questions 3.3.60 and 3.3.100.

If there is no incremental transfer of value in Step 1, there is no EPS effect and no further analysis is needed.

Conversion of convertible preferred shares to other securities

Question 3.3.110

How does an SEC registrant account for the exchange of convertible preferred shares for other securities?

Interpretive response: If a registrant converts convertible preferred shares to other securities issued by the registrant according to the preferred shares' original conversion terms (i.e. not an inducement), there is no incremental transfer of value to the preferred shareholders, and therefore no EPS numerator effect. [260-10-S99-2]

See Question 3.3.80 for conversions that are not according to the preferred shares' original conversion terms (i.e. induced conversions).

3.3.60 Down-round features and modifications or exchanges of equity-classified instruments

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Down-round features in equity-classified financial instruments and convertible preferred stock

Excerpt from ASC 260-10

• > Freestanding Equity-Classified Financial Instrument with a Down Round Feature

45-12B For a freestanding equity-classified **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) with a **down round feature**, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

A down-round feature is a feature that reduces the conversion or exercise price ('strike price') of a convertible instrument or a freestanding equity option or warrant triggered by a future event.

For example, assume an issuing entity has outstanding Instrument A, a freestanding equity warrant with a down-round feature. Subsequently the entity issues Instrument B, a freestanding equity warrant with a strike price that is lower than Instrument A's strike price, which causes the down-round feature in Instrument A to be triggered. Instrument A's strike price would be reduced based on a formula in the terms of Instrument A. See also Question 8.8.170 in KPMG Handbook, Debt and equity financing.

Instruments with down-round features are further discussed in Section 6.18.

Question 3.3.112**

How does a down-round feature in an equity-classified instrument affect EPS?

Interpretive response: When the down-round feature is triggered, economic value related to the feature is transferred to the holders of the instrument. An entity recognizes the value related to the down-round feature in an equity-classified financial instrument (e.g. a freestanding warrant or convertible preferred share) as an increase in additional paid-in capital and a decrease in retained earnings (i.e. as a deemed dividend). This transfer of value reduces income available to common shareholders in the period in which the down-round feature is triggered. [260-10-45-12B]

See section 6.18.20 for determining the value of the effect of a down-round feature when triggered.

Modifications and exchanges of freestanding equity-classified options and warrants

Excerpt from ASC 260-10

• > Issuer's Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

45-15 For a modification or an exchange of a freestanding equity-classified written call **option** described in paragraph 815-40- 35-17(d), an entity shall deduct the effect of the modification or exchange (as measured in accordance with paragraph 815-40-35-16) in computing income available to common stockholders when the modification or exchange is executed by the issuer and the holder or unilaterally by the issuer (see paragraph 815-40-15-7H).

A modification or exchange of an option or warrant may trigger the remeasurement of the instrument, and there may be a difference in the fair value of the instrument before and after the modification or exchange. The incremental value resulting from a modification or exchange that does not represent a cost of financing or compensation in a reciprocal transaction is treated as a deemed dividend. The numerator in basic EPS is adjusted for the incremental fair value of the modified or exchanged warrant. See Question 6.9.50. [260-10-45-15]

Example 3.3.65
Modification of freestanding equity-classified warrants

Year 1 issuance

On January 1, Year 1, ABC Corp. issues 100,000 freestanding warrants.

The following facts are relevant.

- The warrants have a 10-year term, permit the holders to buy common shares for $10 per share and are exercisable at any time.
- Each warrant can be exercised in exchange for five common shares.

ABC classifies the warrants as equity instruments.

Year 2 modification

During Year 2, in light of changes in the market, ABC wishes to induce early exercise of the warrants and reduces the exercise price to $8 each. The warrants remain equity-classified.

- The incremental fair value of the warrants is calculated as $100,000.
- Net income for Year 2 is $1,000,000.

Basic EPS numerator calculation – Year 2

Basic EPS

1 Determine the numerator

The excess of the fair value of the modified warrants over the fair value of the warrants under the original terms (‘incremental fair value’) is deducted from net income to determine the income available to common shareholders.

Net income	$1,000,000
Incremental fair value	(100,000)
Income available to common shareholders	**$900,000**

Accordingly, the numerator is $900,000.

3.3.70 Returns on participating equity instruments and other classes of common shares

The capital structure of some entities may include:

— equity instruments that participate in dividends with common shares according to a predetermined formula with, at times, an upper limit on the extent of participation (participating equity instruments); and/or

— a class of common shares with a dividend rate different from that of another class of common shares but without prior or senior rights.

To determine the income that is available to common shareholders, the earnings (loss) for the period is allocated to the different classes of common shares and participating equity instruments. This allocation is made in accordance with the rights of the various classes of securities to participate in distributions or other rights to participate in undistributed earnings.

Where to find additional guidance on determining basic EPS depends on whether the dividends to which the instruments are entitled are forfeitable.

— If the instruments are entitled to nonforfeitable dividends, see chapter 5.
— If the dividends are forfeitable, see Questions 3.3.35 (liability-classified instruments) and 3.3.117 (equity-classified instruments).

Question 3.3.115

What is the effect on the EPS numerator of modifications or exchanges of *common* shares?

Interpretive response: A modification or exchange of *common* shares generally does not have an EPS effect unless:

— the entity has multiple classes of common shares and it results in one class of common share receiving a deemed dividend: or
— the modification or exchange results in the creation of a different class of common shares.

If the fair value of the modified common shares is greater than the fair value of the original common shares, the excess represents a deemed dividend to the holders of the different class of shares. This would also require calculating EPS using the two-class method (see section 5.2) because of the other class of shares receiving the deemed dividend. [260-10-45-59A]

Question 3.3.117

How are forfeitable dividends on equity-classified instruments treated when calculating basic EPS?

Background: Certain equity-classified instruments, such as contingent share agreements or share-based payment awards, may receive dividends that are forfeitable until the contingency is met or the awards vest. These may include restricted stock awards that accrue dividends that the holders are entitled to receive only upon vesting of the awards.

Forfeitable dividends paid on share-based payment awards are not recognized as additional compensation cost under Topic 718. Therefore, these dividends do not affect earnings. [260-10-45-68B]

Interpretive response: Forfeitable dividends do not convey a participation right, and therefore the two-class method is not used for these instruments (see Question 5.2.45). However, we believe to calculate basic EPS, income available to common shareholders should be reduced for forfeitable dividends, or dividend equivalents, on equity-classified instruments, in the period when those dividends reduce retained earnings (i.e. when declared). If the dividends are subsequently forfeited, the adjustment to income available to common shareholders is reversed in the period of forfeiture.

We acknowledge that there is diversity in practice in how entities treat forfeitable dividends, and it may also be acceptable to make no adjustment to income available to common shareholders for forfeitable dividends, or dividend equivalents when declared. Subsequently, when the dividends are no longer forfeitable, such as if the contingency is met or the share-based payment awards vest into common shares, the previously forfeitable dividends would then be dividends paid on common shares (and would not require any adjustment to income available to common shareholders).

We believe an entity should consistently apply and disclose its policy related to the treatment of forfeitable dividends on these instruments.

See also section 4.4.40 for guidance on numerator adjustments for diluted EPS, and section 6.9.20 for guidance on how options, warrants and forward sale contracts are included in EPS. See Question 3.3.35 for a discussion on the treatment of dividends on liability-classified instruments.

3.3.80 NCI considerations

Excerpt from ASC 260-10

• > Income Available to Common Stockholders and Preferred Dividends

45-11A For purposes of computing EPS in **consolidated financial statements** (both basic and diluted), if one or more less-than-wholly-owned **subsidiaries** are included in the **consolidated group**, income from continuing operations and net income shall exclude the income attributable to the **noncontrolling interest** in subsidiaries. Example 7 (see paragraph 260-10-55-64) provides an example of calculating EPS when there is a noncontrolling interest in a subsidiary in the consolidated group.

When determining basic EPS for consolidated financial statements, the numerator is the income (loss) that is available to common shareholders of the parent entity. This 'income (loss)' refers to the income (loss) of the consolidated entity after adjusting for the share of income (loss) attributable to NCI and for the items that are discussed in the other sections of this chapter. [260-10-45-11A]

When the NCI is redeemable, as noted in Question 3.3.20, SEC guidance requires an equity instrument with a redemption feature that is not solely within the control of the issuer to be classified outside of permanent equity – often referred to as classification in temporary or mezzanine equity.

Adjustments to the carrying amount of these instruments do not affect net income or comprehensive income but may affect the EPS calculation. This is because they are treated like the repurchase of NCI, although they may be recorded in retained earnings instead of additional paid-in capital. [480-10-S99-3A.22]

Question 3.3.119**

How does NCI in the form of a subsidiary's redeemable common shares affect the parent's EPS?

Interpretive response: When the redeemable NCI is in the form of common shares, the effect depends on whether the redemption price is at fair value. When the redemption price is at other than fair value, the two-class method is used to calculate EPS at the subsidiary level, with one class being the redeemable NCI and the other class being the shares held by the parent. Otherwise, EPS for the subsidiary is calculated in the regular manner. In either case, the resulting subsidiary EPS is then used to calculate the parent's share of income to include in its EPS numerator. If the two-class method is used, the parent's share of income is calculated using the EPS for the parent's shares. See Questions 3.3.20 and 5.3.40. [260-10-45-11(a), 480-10-S99-3A.22(b)]

Question 3.3.120#

How does NCI in the form of a subsidiary's redeemable preferred shares affect the parent's EPS?

Interpretive response: The effect on income available to common shareholders of the parent arising from adjustments to the carrying amount of a redeemable NCI in the form of preferred shares depends on whether:

— the preferred shares are the only NCI in the subsidiary; and
— the redemption feature embedded in the preferred share was issued, or is guaranteed, by the parent.

Preferred shares are the only NCI

If there are no other NCI in the subsidiary that issued redeemable preferred shares (regardless of whether the redemption feature was issued or is guaranteed by the parent), the entire adjustment to the carrying amount of that NCI from applying the SEC temporary equity guidance (as described in Question

3.3.20) reduces or increases the income available to common shareholders of the parent.

See Example 7.5.80 in KPMG Handbook, Consolidation, for an illustration of NCI in the form of redeemable preferred shares, including EPS considerations.

Preferred shares are not the only NCI

If there is NCI in the subsidiary in the form of common shares (in addition to NCI in the form of preferred shares), the effect on the income available to common shareholders of the parent depends on whether the redemption feature embedded in the preferred shares was issued, or is guaranteed, by the parent.

— **Issued or guaranteed by the parent.** The entire adjustment to the carrying amount will reduce or increase income available to common shareholders of the parent.

— **Not issued or guaranteed by the parent.** The adjustment is attributed to the parent and the other NCI – i.e. NCI in the form of common shares. Securities issued by a subsidiary that enable the holders to obtain the subsidiary's common shares are included in the calculation of the subsidiary's EPS information; the per-share earnings of the subsidiary are then included in the parent/consolidated EPS calculations based on the consolidated entity's holdings of the subsidiary's securities.

Question 3.3.130

How do profit-sharing arrangements and guarantees between a parent and NCI affect EPS?

Interpretive response: A parent and the noncontrolling shareholders of a subsidiary may enter into an arrangement to share earnings (losses) in a manner other than in proportion to their ownership interests (i.e. a profit-sharing arrangement) or to place the parent under an obligation to absorb losses attributable to NCI.

We believe that for basic EPS, the parent should adjust the numerator to take into account any obligations to cover losses that are attributable to NCI that are not already reflected in earnings.

Example 3.3.70

Obligation to cover NCI losses

Parent has an 80% interest in Subsidiary. Parent's consolidated net income for the year (excluding Parent's share of Subsidiary's results) is $5,000 and Subsidiary's loss for the year is $750.

— Scenario 1: Parent has no obligation to cover Subsidiary's losses attributable to NCI.
— Scenario 2: Parent is obligated to cover Subsidiary's losses attributable to NCI.

Basic EPS numerator calculation

Basic EPS

1 Determine the numerator

Parent's share in Subsidiary's losses is deducted from net income to determine the income available to common shareholders.

	Scenario 1	Scenario 2
Net income	$5,000	$5,000
Parent's share in Subsidiary's losses:		
Scenario 1: [$750 ×80%]	(600)	
Scenario 2: [$750 ×100%]		(750)
Income available to common shareholders	**$4,400**	**$4,250**

Accordingly, the numerator is $4,400 and $4,250 for Scenarios 1 and 2, respectively.

3.4 Step 2: Determine the denominator

3.4.10 What number of shares to use?

Excerpt from ASC 260-10

• > Computing a Weighted-Average

55-2 The weighted-average number of shares is an arithmetical mean average of shares outstanding and assumed to be outstanding for EPS computations. The most precise average would be the sum of the shares determined on a daily basis divided by the number of days in the period. Less-precise averaging methods may be used, however, as long as they produce reasonable results. Methods that introduce artificial weighting, such as the Rule of 78 method, are not acceptable for computing a weighted-average number of shares for EPS computations.

• > Treatment of Contingently Issuable Shares in Weighted-Average Shares Outstanding

45-12C Contractual agreements (usually associated with purchase business combinations) sometimes provide for the issuance of additional common shares contingent upon certain conditions being met. Consistent with the objective that basic EPS should represent a measure of the performance of an entity over a specific reporting period, **contingently issuable shares** should be included in basic EPS only when there is no circumstance under which those shares would not be issued and basic EPS should not be restated for changed circumstances.

45-13 Shares issuable for little or no cash consideration upon the satisfaction of certain conditions (contingently issuable shares) shall be considered outstanding common shares and included in the computation of basic EPS as of the date that all necessary conditions have been satisfied (in essence, when issuance of the shares is no longer contingent). Outstanding common shares that are contingently returnable (that is, subject to recall) shall be treated in the same manner as contingently issuable shares. Thus, contingently issuable shares include shares that meet any of the following criteria:

a. They will be issued in the future upon the satisfaction of specified conditions.
b. They have been placed in escrow and all or part must be returned if specified conditions are not met.
c. They have been issued but the holder must return all or part if specified conditions are not met.

45-14 See paragraph 710-10-05-8 for guidance related to rabbi trust shares.

• > Partially Paid Shares and Partially Paid Stock Subscriptions

55-23 If an entity has common shares issued in a partially paid form (permitted in some countries) and those shares are entitled to dividends in proportion to the amount paid, the common-share equivalent of those partially paid shares shall be included in the computation of basic EPS to the extent that they were entitled to participate in dividends. Partially paid stock subscriptions that do not share in dividends until fully paid are considered the equivalent of warrants and shall be included in diluted EPS by use of the treasury stock method. That is, the unpaid balance shall be assumed to be proceeds used to purchase stock under the treasury stock method. The number of shares included in diluted EPS shall be the difference between the number of shares subscribed and the number of shares assumed to be purchased.

The denominator of the basic EPS calculation is the weighted-average number of common shares outstanding during the reporting period.

	Weighted-average number of shares outstanding during the period	
Step 2: Determine the denominator	When shares become outstanding: general principles	Section 3.4.20
	Should these shares be included? — Contingently issuable shares [260-10-45-12C] — Potential common shares exercisable for nominal consideration [260-10-45-13] — Potential common shares exercisable for other than nominal consideration — Partially paid common shares [260-10-55-23] — Redeemable common stock classified as equity — Redeemable common stock classified as liability — Treasury shares [260-10-55-10] — Own shares held by employee benefit plans — Own shares underlying an employee share purchase plan — Dividends payable in common shares — Share-based payment awards	Section 3.4.30

	Weighted-average number of shares outstanding during the period	
	Changes in the number of outstanding common shares without corresponding changes in resources	Section 3.4.40

The weighted-average number of shares outstanding is "the number of shares determined by relating the portion of time within a reporting period that common shares have been outstanding to the total time in that period." The weighted average is used so that the effect of any increase or decrease in the number of common shares on the EPS calculation is related only to the portion of the period during which the related resources are available for use in the entity's operations. [260-10 Glossary]

To determine the weighted average during a reporting period, the number of outstanding common shares at the beginning of the period is generally adjusted by the number of common shares bought back or issued during the period multiplied by a time-weighting factor. However, in certain situations (e.g. if there was a stock split during the period) retrospective adjustment is also made to the denominator (see section 7.3).

While it is more precise to calculate the weighted-average using a daily average, Topic 260 does not require it. Less precise averaging methods may be used if the results are reasonable. This might involve monthly averaging, or basing the average on weeks, or parts of months rather than on the precise number of days. However, methods that use an artificial weighting may not be used. [260-10-55-2]

Example 3.4.10
Denominator – simple example

ABC Corp. has the following capital structure.

Dates in Year 1	Transaction	Common shares
January 1	Balance	1,000,000
July 1	Common shares issued for cash	500,000
September 1	Common shares issued for cash	500,000
December 31	Balance	2,000,000

Basic EPS denominator calculation

Basic EPS denominator calculation

2 Determine the denominator

The second step in the basic EPS calculation is to determine the weighted-average number of common shares outstanding for the reporting period.

The weighted-average number of outstanding common shares for Year 1 is calculated as follows.

	Number of shares	Time weighting	Weighted average
Jan. 1 – June 30	1,000,000	6/12	500,000
July 1 – shares issued	500,000		
July 1 – August 31	1,500,000	2/12	250,000
Sept. 1 – shares issued	500,000		
Sept. 1 – Dec. 31	2,000,000	4/12	666,667
		12/12	
Weighted-average number of shares outstanding			**1,416,667**

This example uses monthly averaging for the number of shares outstanding. However, an entity should determine the weighted-average shares outstanding calculation approach that is most reasonable based on its facts and circumstances.

3.4.20 When shares become outstanding – general principles

Common shares are usually considered 'outstanding' from the date on which the corresponding consideration is received. In all cases, the precise timing of the inclusion of common shares as being outstanding is determined by their terms and conditions, after considering the substance of any contract associated with their issuance. [505-10-45-2]

The following table sets out the general principles in this regard.

Common shares issued	Time from which shares are 'outstanding'	Discussion
For cash	Generally when cash is received[1]	Sections 6.2 and 6.3
For another asset	When the asset is recognized	Section 6.6
To settle a liability	Settlement date	Section 6.5
On conversion of a debt instrument	Date on which interest ceases to accrue	Section 6.12
In lieu of interest or principal on other financial instruments	Date on which interest ceases to accrue	Section 6.5
On voluntary reinvestment of dividends	Date on which dividends are reinvested	Section 6.4
As compensation for services received	When the services are rendered	Sections 6.8 – 6.13

Common shares issued	Time from which shares are 'outstanding'	Discussion
As consideration in a business combination	Date of acquisition	Section 6.7
Note: 1. If not outstanding, the shares may still be a participating security (see Question 6.2.10).		

3.4.30 Should these shares be included?

The denominator of the basic EPS calculation is generally limited to common shares that were outstanding during the period; however, shares that have not been issued, and that relate to specific instruments, are included in certain circumstances. Instruments that are not included in basic EPS and are settleable in shares are generally considered potential common shares and included in diluted EPS (see chapter 4).

Contingently issuable and potential common shares#

Contingently issuable shares are included in the basic EPS calculation only when there is no circumstance under which they would not be issued, other than the passage of time or conditions within the counterparty's control. [260-10-45-12C, 45-13]

— When contingently issuable shares are issuable for cash consideration, they are not deemed issuable until that consideration is paid (and any other conditions have been satisfied).

— In contrast, if they are issuable for little or no cash consideration, the payment of the consideration is not a contingency, meaning that they are considered issuable once any other conditions, other than the passage of time, that make them issuable have been satisfied. Therefore, at that point, they are included in the basic EPS calculation even though they have not yet been legally issued.

Scenario	Include?	Commentary
Contingently issuable common shares	?	— Contingently issuable shares are not considered outstanding common shares and they are not included in the calculation of basic EPS until the date on which all necessary conditions for issuance have been satisfied. — However, if a minimum number of shares will be delivered and all the necessary conditions for their issuance have been satisfied except for the passage of time, that minimum should be included in calculating basic EPS. Basic EPS is not retrospectively adjusted for changed circumstances related to contingently issuable shares. Example 3 in Topic 260 (reproduced below) illustrates the effect of

Scenario	Include?	Commentary
		contingently issuable shares on the basic (and diluted – see chapter 4) EPS calculations. A continued service requirement in a share-based payment award is considered a contingency and the shares are not included in the calculation of basic EPS until the services have been rendered. Shares must be vested to be included in basic EPS calculations. [260-10-45-12C – 45-13]
Contingently returnable common shares	?	Treated similar to contingently issuable shares; include when all conditions have been satisfied and shares are no longer returnable (or no longer subject to recall). [260-10-45-13]
Potential common shares exercisable for little or no consideration – equity-classified	?	The exercise of such options (e.g. penny warrants) is virtually assured because the underlying common shares will be issued for little or no cash consideration – i.e. the stated exercise price is nonsubstantive. All necessary conditions for issuance of the underlying common shares are met when those options or warrants are issued; therefore, those shares should be included in the denominator of both the basic (and diluted – see chapter 4) EPS calculations. [260-10-45-13] If the potential common shares are restricted stock or RSUs issued as part of a share-based payment award, we believe that if the restricted stock or RSUs are vested, they should be included in the calculation of basic EPS. [260-10-45-13]
Potential common shares exercisable for little or no consideration – liability-classified	?	Some believe that for liability-classified warrants, similar to equity-classified warrants, all necessary conditions for issuance of the underlying shares are met and the shares should be included in the denominator of both the basic and diluted EPS calculations. The exercise of those options or penny warrants is virtually assured, because the underlying common shares will be issued for little or no cash consideration – i.e. the stated exercise price is nonsubstantive. [260-10-45-13] However, others believe that a liability-classified warrant differs from an equity-classified warrant because consideration is provided when exercising the penny warrant – i.e. consideration includes the legal extinguishment of a liability in addition to the penny exercise price. Under this view, because the shares are not issuable for little or no cash consideration, liability-classified warrants are not in the scope of paragraph 260-10-45-13 and therefore should not be included in the denominator of basic EPS calculations. Absent further guidance from the SEC or FASB staff, we believe that both views are acceptable (see Question 3.4.10).

Scenario	Include?	Commentary
Potential common shares exercisable for other than nominal consideration	✗	Unless they are issuable for little or no cash consideration upon the satisfaction of certain conditions (see above), unexercised options, warrants and other convertible instruments do not affect the denominator of the basic EPS calculation until the shares have been issued, and then the shares are weighted for only the period of time outstanding.

The following table explains how other types of shares affect the basic EPS calculation.

Scenario	Include?	Commentary
Partially paid common shares	✓	Included as a fraction of a common share to the extent they are entitled to participate in dividends during the period relative to a fully paid common share (see section 6.3). For example, if 1,000 shares are issued and are 50% paid, 500 shares are included. [260-10-55-23]
Redeemable common shares classified as temporary equity	✓	Generally, the number of common shares underlying the balance for redeemable common shares classified in temporary equity is included in the weighted-average number of common shares outstanding (the denominator of the EPS calculation) in the same manner as common shares that are not redeemable. However, the manner in which EPS is calculated depends on whether the common shares are redeemable at fair value or other than fair value (see Question 3.3.20).
Redeemable common shares classified as a liability	✗	Redeemable common shares that are classified as a liability are not included in basic (and diluted – see chapter 4 and section 6.14.20) EPS. Dividends and other adjustments to the carrying amount of these shares are recognized in earnings as interest expense and therefore are not included in income available to common shareholders. See also Question 3.3.30.
Treasury shares	✗	Treasury shares are an entity's own common shares reacquired and held by the entity. In the consolidated financial statements, treasury shares also include the parent's shares that are held by its subsidiaries. Treasury shares are not regarded as outstanding and are excluded from the denominator for the period during which they are held by the entity. This reflects the rationale underlying the use of the weighted-average number of common shares, because the consideration spent in reacquiring own shares is no longer available for use in the entity's operations. [260-10-45-10]

Scenario	Include?	Commentary
Own shares held by employee benefit plans	✔	Assets held by employee benefit plans may include an entity's own shares. An entity's common shares that are qualifying plan assets held by its employee benefit plan and netted against the employee benefit obligation are not the entity's treasury shares for financial reporting purposes. Accordingly, we believe these shares should be considered outstanding when calculating basic EPS. However, if an entity's own shares held by its employee benefit plan do not meet the definition of plan assets, they are presented as treasury shares; in this case, we believe these shares should not be considered outstanding when calculating basic EPS.
Own shares underlying an employee share purchase plan	?	It depends on whether the amounts currently available to purchase shares are refundable to the employee. — **Amount is refundable.** The substance of the plan is that the employee is being issued an option each pay period or each time a contribution is made to the plan. Therefore, the shares currently purchasable are not included in the weighted-average shares outstanding in the calculation of basic EPS. — **Amount is not refundable.** The shares currently purchasable by the employee are included in basic EPS. The number of shares currently purchasable is determined using the plan price. See section 6.20.20.
Dividends payable in common shares	?	Preferred shares may require dividends to be paid in common shares, or an entity may irrevocably elect to pay preferred share dividends in common shares. In either case, the number of common shares to be issued to the preferred shareholders is included in the denominator of the basic EPS calculation; this is done as of the dividend declaration date if the number of common shares to be issued is fixed at that time. The amount of the dividend is also deducted in determining the income available to common shareholders in the numerator (see section 3.3). However, if the entity can elect to pay preferred share dividends in cash or in common shares until the payment date, it adds no additional shares to the denominator of the basic EPS calculation until the shares are issued.
Mandatorily convertible instruments – predetermined date	✘	Some entities issue preferred shares that are mandatorily convertible into their common shares at a predetermined date. These preferred shares typically earn a distinct rate of return before

Scenario	Include?	Commentary
		conversion (e.g. a fixed-dividend rate), and the return is forfeited when the shares are converted. We believe the treatment for mandatorily convertible preferred shares should be no different from the treatment of convertible instruments for EPS purposes (see chapter 6), *if* the mandatorily convertible preferred shares have distinct return characteristics apart from the right to common shares in the future. We also believe this distinguishes these instruments from the noncontingent securities described in paragraph 260-10-45-13 (issuable for little or no cash consideration). Further, these mandatorily redeemable preferred shares typically lack the right before conversion to participate in dividends with common shareholders; however, instruments with participation rights should be considered participating securities as described in chapter 5. Similarly, an entity may issue convertible debt that is mandatorily convertible at a predetermined date. We believe the same treatment applies to mandatorily convertible debt.
Share-based payment awards	?	Unvested share-based payment awards do not meet the criteria in paragraphs 260-10-45-12C for basic EPS. Vested share-based payment option awards also do not meet those criteria for basic EPS until exercised. However, as discussed in Question 6.10.10, shares that vest when an employee retires are included in basic EPS from the date the employee reaches retirement eligibility and no longer has to provide future employment to retain the awards.

Basic EPS is not retrospectively adjusted for changed circumstances related to contingently issuable shares. Example 3 in Topic 260 (reproduced below) illustrates the effect of contingently issuable shares on the basic and diluted EPS calculations.

Excerpt from ASC 260-10

• > Example 3: Contingently Issuable Shares

55-53 This Example illustrates the contingent share provisions described in paragraphs 260-10-45-13 and 260-10-45-48 through 45-57. This Example has the following assumptions:

a. Entity A had 100,000 shares of common stock outstanding during the entire year ended December 31, 20X1. It had no options, warrants, or convertible securities outstanding during the period.
b. Terms of a **contingent stock agreement** related to a recent business combination provided the following to certain shareholders of Entity A:
   1. 1,000 additional common shares for each new retail site opened during 20X1
   2. 5 additional common shares for each $100 of consolidated, after-tax net income in excess of $500,000 for the year ended December 31, 20X1.
c. Entity A opened two new retail sites during the year:
   1. One on May 1, 20X1
   2. One on September 1, 20X1.
d. Entity A's consolidated, year-to-date after-tax net income was:
   1. $400,000 as of March 31, 20X1
   2. $600,000 as of June 30, 20X1
   3. $450,000 as of September 30, 20X1
   4. $700,000 as of December 31, 20X1.

55-54 Note that in computing diluted EPS for an interim period, contingent shares are included as of the beginning of the period. For year-to-date computations, paragraph 260-10-45-49 requires that contingent shares be included on a weighted-average basis.

55-55 The following table illustrates the quarterly and annual calculation of basic and diluted EPS.

55-56

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Basic EPS Computation					
Numerator	$ 400,000	$ 200,000	$ (150,000)	$ 250,000	$ 700,000
Denominator:					
Common shares outstanding	100,000	100,000	100,000	100,000	100,000
Retail site contingency	0	667[(a)]	1,333[(b)]	2,000	1,000[(c)]
Earnings contingency[(d)]	0	0	0	0	0
Total shares	100,000	100,667	101,333	102,000	101,000
Basic EPS	$ 4.00	$ 1.99	$ (1.48)	$ 2.45	$ 6.93

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Diluted EPS Computation					
Numerator	$ 400,000	$ 200,000	$ (150,000)	$ 250,000	$ 700,000
Denominator:					
Common shares outstanding	100,000	100,000	100,000	100,000	100,000

Retail site contingency	0	1,000	2,000	2,000	1,250[e]
Earnings contingency	0[f]	5,000[g]	0[h]	10,000[i]	3,750[j]
Total shares	100,000	106,000	102,000	112,000	105,000
Diluted EPS	$ 4.00	$ 1.89	$ (1.47)[k]	$ 2.23	$ 6.67

(a) 1,000 shares × ⅔
(b) 1,000 shares + (1,000 shares × ⅓)
(c) (1,000 shares × 8/12) + (1,000 shares × 4/12)
(d) The earnings contingency has no effect on basic EPS because it is not certain that the condition is satisfied until the end of the contingency period (see paragraphs 260-10-45-50 through 45-57). The effect is negligible for the fourth-quarter and full-year computations because it is not certain that the condition is met until the last day of the period.
(e) (0 + 1,000 + 2,000 + 2,000) ÷ 4
(f) Entity A did not have $500,000 year-to-date, after-tax net income at March 31, 20X1. Projecting future earnings levels and including the related contingent shares are not permitted by this Subtopic.
(g) [($600,000 – $500,000) ÷ $100] × 5 shares
(h) Year-to-date, after-tax net income was less than $500,000.
(i) [($700,000 – $500,000) ÷ $100] × 5 shares
(j) (0 + 5,000 + 0 + 10,000) ÷ 4
(k) Loss during the third quarter is due to an extraordinary item; therefore, antidilution rules (see paragraph 260-10-45-17) do not apply.

Observation

Evaluate substance over form to determine shares included in basic EPS

An entity should take care in evaluating substance over form to determine if shares should be included in basic EPS. Some share arrangements have features that make them contingently returnable.

For example, unvested options with little or no consideration may permit early exercise. These appear to have no contingency; however, if, after early exercise of the options, the entity has the right to repurchase those shares if the employee terminates employment before vesting, they are considered contingently returnable shares and should not be included in basic EPS until the contingency period ends. [260-10-45-13]

Also, shares may be called 'common' but contain a preference, and shares may be called 'preferred' but in essence have no preference and represent a different class of common shares. Therefore, the terms and conditions of an entity's shares must be evaluated to determine whether they are common or preferred shares. See also Question 2.2.100.

Question 3.4.05

If share issuance is subject to shareholder approval, should these shares be included in basic EPS?

Interpretive response: No. Shares subject to shareholder approval are contingently issuable shares. They are included in basic EPS only when there is no circumstance under which those shares would not be issued. Therefore, even if approval is anticipated, the shares are not included in basic EPS until approval actually occurs. [260-10-45-12C]

Question 3.4.08

Are shares underlying either award exercises or restricted awards, where restrictions have lapsed, included in basic EPS?

Interpretive response: Yes. If shares have not yet been issued, but all conditions for their issuance have been fulfilled, they are included in basic EPS. If options were exercised, or restrictions have lapsed on a restricted share award, the underlying shares are included in basic EPS regardless of whether they have been issued. [260-10-45-12C]

Question 3.4.10

Are warrants exercisable for nominal consideration considered contingently issuable common shares?

Interpretive response: Some entities issue equity-classified warrants to purchase common shares that are exercisable for nominal (little or no) consideration. For example, warrants issued with an exercise price of $0.01 per share when the entity's share price is hundreds of times greater than $0.01 per share do not, in substance, have an exercise price.

Such warrants can be classified as either equity or liabilities, depending on the facts and circumstances. Paragraph 260-10-45-13 controls how these warrants affect EPS calculations. Under that paragraph, these instruments are no longer contingently issuable shares when there are no conditions that must be satisfied before issuance of the underlying common shares.

Warrants classified as equity

The exercise of such options or penny warrants is virtually assured because the underlying common shares will be issued for little or no cash consideration – i.e. the stated exercise price is nonsubstantive. All necessary conditions for issuance of the underlying common shares are met when those warrants are issued; therefore, those shares are included in the denominator of both the basic and diluted (see chapter 4) EPS calculations. [260-10-45-13]

Warrants classified as liabilities

Some believe that similar to equity-classified warrants, all of the conditions in paragraph 260-10-45-13 are met and the shares should be included in the denominator of both the basic and diluted (see chapter 4) EPS calculations. The exercise of those options or penny warrants is virtually assured, because the underlying common shares will be issued for little or no cash consideration – i.e. the stated exercise price is nonsubstantive.

However, others believe that a liability-classified warrant differs from an equity-classified warrant because consideration is provided when exercising the penny warrant – i.e. consideration includes the legal extinguishment of a liability in addition to the penny exercise price. Under this view, because the shares are not issuable for little or no cash consideration, liability-classified warrants are not in the scope of paragraph 260-10-45-13 and therefore should not be included in the denominator of the basic EPS calculations but would be included in diluted EPS.

We believe that both views are acceptable.

Question 3.4.20

Are shares in an own-share lending arrangement included in the denominator of basic EPS?

Background: An entity may enter into an 'own-share lending arrangement' with a third party, generally an investment bank, in anticipation of a convertible debt offering. As part of the arrangement, the issuer will loan shares to the investment bank to increase the availability of the issuer's shares – to facilitate hedging the conversion feature of the issuer's convertible debt by investors.

Interpretive response: Generally, no. Because they are expected to be returned, shares subject to an own-share lending arrangement are not included in determining basic EPS. An exception arises when default of the share-lending arrangement occurs, at which time the loaned shares are included in the basic (and diluted- see chapter 4) EPS calculation. [470-20-45-2A]

However, if dividends on the loaned shares are not reimbursable to the entity (i.e. dividends are non-forfeitable) based on the terms of the own-share lending agreement, then basic EPS is calculated using the two-class method (see Question 5.2.150). [470-20-45-2A]

Question 3.4.30

Are shares held by a rabbi trust considered contingently issuable shares?

Excerpt from ASC 710-10

Deferred Compensation—Rabbi Trusts

25-15 The following are the four types of deferred compensation arrangements involving rabbi trusts covered by this Subsection:

a. Plan A—The plan does not permit diversification and must be settled by the delivery of a fixed number of shares of employer stock.
b. Plan B—The plan does not permit diversification and may be settled by the delivery of cash or shares of employer stock.

c. Plan C—The plan permits diversification; however, the employee has not diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).
d. Plan D—The plan permits diversification and the employee has diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

> Plan A

25-16 For Plan A, employer stock held by the rabbi trust shall be classified in equity in a manner similar to the manner in which treasury stock (see Subtopic 505-30) is accounted for. The deferred compensation obligation shall be classified as an equity instrument.

> Plans B and C

25-17 For Plans B and C, employer stock held by the rabbi trust shall be classified in equity in a manner similar to the manner in which treasury stock (see Subtopic 505-30) is accounted for. The deferred compensation obligation shall be classified as a liability.

> Plan D

25-18 For Plan D, assets held by the rabbi trust shall be accounted for in accordance with generally accepted accounting principles (GAAP) for the particular asset (for example, if the diversified asset is an equity security, that security would be accounted for in accordance with Subtopic 321-10). The deferred compensation obligation shall be classified as a liability. At acquisition, debt securities held by the rabbi trust may be classified as trading.

Background: A rabbi trust is an irrevocable grantor trust that is generally used to fund deferred compensation arrangements for highly paid executives or a select group of management. Assets are set aside in the rabbi trust related to the future payment of benefits under the deferred compensation plan. These assets are also used to provide tax deferral options for those in the plan. The employer will normally not have access to the trust because the trust is restricted, although legally the assets remain those of the employer.

Paragraph 710-10-25-15 discusses four types (A, B, C and D) of deferred compensation arrangements involving rabbi trusts.

Interpretive response: For most types of these deferred compensation arrangements, the *employer shares* held by the rabbi trust are treated as treasury stock and excluded from the denominator in basic and diluted EPS. [710-10-45-3]

However, *the obligation* under the deferred compensation arrangement is reflected in the denominator of the EPS computation under Section 260-10-45. [710-10-45-4, 25 –15-18, 260-10-45-13]

— For Plan A arrangements, which are settled only by the delivery of shares of employer stock, the deferred compensation obligation is classified as an equity instrument. As a result, the shares to be issued to settle the obligation are included in basic and diluted EPS when they are placed in the rabbi trust.

— For other Plan types (B, C and D), the obligation can be settled other than in shares, and therefore the underlying deferred compensation obligation is classified as a liability. For these plan types, the shares to be issued to settle the underlying obligation are not reflected in basic EPS. However, they are reflected in diluted EPS as potential common shares, following the guidance on contracts that can be settled in cash or stock (see also section 6.13).

Question 3.4.40

Are shares issued for a recourse note considered outstanding?

Interpretive response: When shares are issued as consideration for a recourse note issued by the holder, we believe an entity should consider the facts and circumstances to evaluate its substance and effect on EPS. Depending on the circumstances, if the entity has recourse if the shareholder defaults on the note, the shares may be considered outstanding.

Question 3.4.50

Are share-based payment awards issued for a nonrecourse note considered outstanding?

Interpretive response: When shares granted under share-based payment arrangements are issued as consideration for a nonrecourse note, the share-based payment award is treated like an option until the related note is repaid; this is because the employee, until repayment of the note, can simply return the shares in lieu of payment. Therefore, the note and the shares are not recorded as equity transactions.

Principal and interest payments received on the nonrecourse note are treated as deposits, and their treatment will depend on whether they are refundable or nonrefundable.

— **Deposits are refundable.** A liability is recognized until the liability is paid. In this case, the shares are not outstanding for basic or diluted EPS until the note is fully paid.

— **Deposits are nonrefundable.** Additional paid-in capital is credited for the payment and the shares are not considered outstanding for basic EPS purposes until the note is fully paid. However, the shares are considered in the diluted EPS calculation using the treasury stock method, similar to the treatment of share-based payment award options (see section 6.9).

3.4.40 Changes in the number of outstanding common shares without corresponding changes in resources

The events that have been discussed so far in this chapter relate to a change in an entity's number of outstanding common shares that has a corresponding change in the resources available for use in its operations. For example, in the simplest case in which common shares are issued for cash, the weighted-average number of shares outstanding used in the denominator of the basic EPS calculation is adjusted from the date on which the change in resources (cash) is recognized – i.e. when the cash proceeds from the issuance of shares was received.

However, the number of outstanding common shares may increase or decrease without a corresponding change in resources. For example, the number of shares may increase as a result of an equity restructuring (e.g. a stock dividend or stock split) or decrease as a result of a share consolidation (i.e. reverse stock split). In such cases, common shares are effectively issued or cancelled for no consideration and therefore these events do not contribute to the earning capacity of an entity.

Taking into account the change in the number of common shares only from the date of these capital events would give an odd result of a significant change in an entity's profitability when there has only been a redenomination of shares.

As a result, when there is an equity restructuring that has the effect of changing the number of shares outstanding without a corresponding change in resources, the weighted-average number of shares outstanding for the entire period is retrospectively adjusted as if the change had occurred at the beginning of the first period of EPS information presented.

Further, such retrospective adjustment is required when these changes occur after the reporting date but before the financial statements for that reporting period are issued (available to be issued).

Retrospective adjustments are further considered in chapter 7.

3.5 Applying the three-step approach

The following example illustrates applying the three-step approach to calculating basic EPS.

Example 3.5.10
Basic EPS – simple example

ABC Corp. has both common shares and equity-classified preferred shares outstanding. The reconciliation of the total (not weighted-average) number of each class and type of shares during Year 1 is set out below.

Dates in Year 1	Transaction	Common shares	Treasury shares	Preferred shares
January 1	Balance	3,000,000	(500,000)	500,000
January 15	Stock dividend – 5% (no corresponding change in resources)	150,000	(25,000)	
February 1	Share repurchase	–	(200,000)	–
August 1	Shares issued for cash	400,000	–	–
December 31	**Balance**	**3,550,000**	**(725,000)**	**500,000**

The following additional information is relevant for Year 1.

— Net income for the year is $4,600,000.

— On November 15, noncumulative preferred dividends of $1.20 per share were declared. The dividends were paid on December 15. Preferred shares do not participate in additional dividends with common shares.

Basic EPS calculation

Basic EPS calculation

1 Determine the numerator

The first step in the basic EPS calculation is to determine income available to common shareholders of ABC for the period.

In this example, there is no discontinued operation; therefore, there is no need to determine a separate basic EPS for the net income, continuing and discontinued operations.

Noncumulative dividends paid on equity-classified preferred shares are not deducted in arriving at net income (loss) for the period, but they also are not considered returns to common shareholders. Accordingly, these dividends are deducted from net income (loss) for the period in arriving at the numerator.

Net income	$4,600,000
Preferred dividends [500,000 × $1.20]	(600,000)
Income available to ABC's common shareholders	**$4,000,000**

Accordingly, the numerator is $4,000,000.

2 Determine the denominator

The second step in the basic EPS calculation is to determine the weighted-average number of common shares outstanding for the reporting period. In the calculation below, the number of months or parts of months, rather than the number of days, has been used as an approximation (see section 3.4.10).

	Number of shares	Time weighting	Weighted average
January 1 – opening balance	2,500,000		
January 15 – stock dividend	125,000		
January 1 to January 31	2,625,000	1/12	218,750[1]
February 1 – share repurchase	(200,000)		
February 1 to July 31	2,425,000	6/12	1,212,500
August 1 – shares issued	400,000		
August 1 to December 31	2,825,000	5/12	1,177,083
		12/12	
Weighted average for the year			**2,608,333**

Note:

1. The stock dividend changed the number of shares outstanding without a corresponding change in resources. For this reason, the number of shares is retrospectively adjusted to January 1. The stock dividend also affects prior-period EPS amounts (see section 7.3). Therefore, the denominator is 2,608,333.

3 Calculate basic EPS

Basic EPS = \$4,000,000 ÷ 2,608,333 = \$1.53

4. Diluted EPS – The foundations

Detailed contents

Item significantly updated in this edition: #

Examples

4.1 How the standard works

Diluted EPS includes shares that would be issued assuming the exercise and conversion of potential common shares. Adjustments are made to the numerator and denominator used to calculate basic EPS to reflect the income and weighted-average number of shares that would have existed had the potential common shares been common shares during the entire period. However, if the potential common shares were issued during the period, these adjustments reflect only the period between the potential common shares' issuance and the end of the period.

The basic requirements for calculating diluted EPS are:

— do not include potential common shares that are antidilutive – i.e. that increase EPS, turn a loss per share into income, or reduce loss per share; and
— use income from continuing operations as the control number for determining if potential common shares are dilutive or antidilutive.

This Handbook uses a five-step approach to calculating diluted EPS.

Step 1	**Identify potential common shares** Is issuance of shares contingent upon a future event (other than the passage of time, or service)? — **Yes.** Include the shares in the diluted EPS calculation in the period that the contingency is met, or if the contingency would be met if the period-end were the end of the contingency period (other than market price triggers in convertible instruments, which are ignored – see section 6.10). — **No.** The shares are not contingent, so include them in the diluted EPS calculation.	Section 4.3
Step 2	**For each class of potential common shares, determine earnings per incremental share (EPIS)** — Calculate for each class of potential common shares separately: – convertible instruments – use if-converted method; – options, warrants and equivalents – use treasury stock method; and – share-based payments – use treasury stock method. — Adjust numerator for income statement effects of convertible instruments, and dividends on convertible preferred shares — Adjust denominator for shares to be issued on conversion/exercise of potential common shares	Section 4.4
Step 3	**Rank potential common shares based on EPIS** — In order of dilution beginning with most the dilutive – i.e. smallest EPIS.	Section 4.5

Step 4 4	**Determine basic EPS based on income from continuing operations** — Use income from continuing operations available to common shareholders.	Section 4.6
Step 5 5	**Identify dilutive potential common shares and determine diluted EPS** — Begin with basic EPS from continuing operations. — Sequence calculation – add each class of instruments from most dilutive to least dilutive. — **Stop** when adding a class that would result in a higher EPS (lower loss per share); the previously calculated EPS is the diluted EPS. — Calculate EPS from discontinued operations and net income. – Use the same weighted-average number of shares used in the calculation of diluted EPS from continuing operations. – Calculate diluted EPS from discontinued operations and net income even if inclusion of potential common shares is antidilutive on either of these EPS measures. However, numerator adjustments are made to EPS from discontinued operations only if they relate to instruments held by the discontinued operations (e.g. interest on convertible debt); otherwise the adjustments would be double-counted.	Section 4.7

4.2 Overview

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

> Diluted EPS

10-2 The objective of diluted EPS is consistent with that of basic EPS—to measure the performance of an entity over the reporting period—while giving effect to all dilutive potential common shares that were outstanding during the period.

• > Computation of Diluted EPS

45-16 The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In computing the dilutive effect of convertible securities, the numerator is adjusted in accordance with the guidance in paragraph 260-10-45-40. Adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods. See Example 1 (paragraph 260-10-55-38) for an illustration of this guidance.

Entities often issue financial instruments or enter into other contracts that may entitle their holders to common shares in the future. For example, an entity may issue a bond that is convertible into its common shares. These financial instruments or other contracts are referred to as ‘potential common stock’ or ‘potential common shares’ in Topic 260 (see chapter 2).

The use of the word ‘may’ is important. This word is used because the financial instruments and contracts referred to above include arrangements that:

— result in common shares being issued only if specified conditions are met (see section 6.10); and
— are not always settled but which ‘may’ be settled in common shares (see Question 4.3.30 and section 6.13).

Effect of potential common shares on basic EPS

Potential common shares do not affect basic EPS until they are exercised or otherwise result in the issuance of common shares or a contingency is met. When this occurs, the weighted-average number of common shares (the denominator) increases. The income (loss) available to common shareholders (the numerator) may also be affected – e.g. when interest on a convertible bond no longer needs to be paid. Depending on the circumstances, the exercise or conversion of potential common shares may result in a decrease (dilution) or an increase (antidilution) in basic EPS (see chapter 3).

Effect of potential common shares on diluted EPS

Basic EPS does not consider the effect of a possible dilution to income available to common shareholders as a result of potential common shares outstanding during a reporting period. 'Diluted' EPS aims to fill this gap, by providing an additional historical performance measure that reflects the potential dilution to the entitlement of existing common shareholders that could occur if all of the dilutive potential common shares outstanding during a reporting period had become outstanding common shares during the period.

To calculate diluted EPS, an entity adjusts both the numerator (if necessary) and the denominator used in the basic EPS calculation for the effects of all dilutive potential common shares.

Numerator in basic EPS + adjustments for dilutive potential common shares	÷	Weighted-average number of outstanding common shares during the reporting period + adjustments for dilutive potential common shares	=	Diluted EPS

— **The numerator is adjusted** to add back dividends or interest on convertible securities that would not have occurred had the potential common shares been common shares for the entire reporting period (e.g. interest expense on convertible debt). [260-10-45-16, 45-40]

— **The denominator is adjusted** to include the shares underlying the potential common shares, as if they were outstanding from the beginning of the period – or for as long as the potential common shares were outstanding (see section 4.4.40). [260-10-45-16]

The objective in determining diluted EPS is to reflect the maximum possible dilutive effect arising from potential common shares outstanding during the period. Therefore, the effects of any antidilutive potential common shares are ignored, and diluted EPS can never give a more favorable impression of an entity's performance than basic EPS from continuing operations.

There are two general methods for including potential common shares in diluted EPS. When a potential common share is also a participating security, the more dilutive of the relevant methods (i.e. treasury stock or if-converted) and the two-class method is used (see chapter 5).

— **Treasury stock method.** Used for *exercisable* instruments (e.g. options, warrants, certain forward sale contracts and written call options, share-based payment awards). The treasury stock method is also used when an investee concurrently holds an investment in the parent entity (referred to as a reciprocal interest – see section 3.3.80 for NCI considerations). Affects only the denominator, although numerator adjustments may also apply to certain instruments (see section 6.13.20).

— **If-converted method.** Used for *convertible* instruments (convertible debt, convertible preferred shares). Affects the numerator and the denominator.

Is the instrument exercisable or convertible?

Exercisable	**Convertible**
Treasury stock method[1]: – Options – Warrants – Forwards	If-converted method: – Convertible debt[3] – Convertible Preferred
↓	↓
Adjust denominator only[2]	Adjust numerator *and* denominator

Notes:

1. The reverse treasury stock method is used for certain forward purchase contracts and put options (see section 6.15).
2. A numerator adjustment may be necessary for certain instruments included using the treasury stock method; however, this is independent of the treasury stock method. See section 6.13.20.
3. For convertible debt instruments that permit or require the payment of cash by the holder at conversion, the if-converted method is used to calculate the numerator adjustment and the treasury stock method is used to calculate the denominator adjustment (see Question 6.12.60).

The rest of this Handbook approaches the diluted EPS calculation using the following five-step approach, which is outlined in greater detail in section 4.1.

Five-step approach to diluted EPS

1. Identify potential common shares (section 4.3).
2. For each potential common share, determine EPIS (section 4.4).
3. Rank potential common shares based on EPIS (section 4.5).
4. Determine basic EPS from continuing operations (section 4.6).
5. Identify dilutive potential common shares and determine diluted EPS (section 4.7).

For additional guidance on calculating diluted EPS for share-based payment awards (including in IPOs, spinoff and carve-out transactions), as well as specific guidance on various instruments, see section 6.9.

4.3 Step 1: Identify potential common shares

The difference between basic and diluted EPS is that diluted EPS includes the effect of potential common shares in the calculation, as discussed in section 4.2. Therefore, the first step to calculating diluted EPS is to identify the potential common shares that are outstanding during the reporting period, regardless of whether they remain outstanding at the reporting date.

The following are examples of potential common shares.

Unvested shares (see section 6.8)	Options, warrants and their equivalents (see section 6.9)	Contingently issuable common shares (see section 6.10)
Convertible instruments (see section 6.12)	Certain forward purchase contracts and written put options (see section 6.15)	Others (see sections 6.3, 6.7, 6.11, 6.13, 6.14, 6.16, and 6.17)

These instruments are not always considered potential common shares for EPS purposes. This is discussed in the referenced sections.

'Classes' of potential common shares

An entity may have multiple potential common shares outstanding during a reporting period. For example, it may have different types of potential common shares (e.g. convertible instruments and unvested shares) or potential common shares of the same type but containing different terms (e.g. stock options with different exercise prices). In this Handbook, potential common shares of different types or of different terms are referred to as different 'classes' of potential common shares.

Identifying different classes of potential common shares is important because different classes are considered separately rather than in aggregate in determining whether each class of potential common shares is dilutive or antidilutive (see section 4.7). For example, stock options that have different exercise prices or exercise periods need to be considered separately.
[260-20-45-18]

Question 4.3.10#

How are mandatorily convertible instruments considered for diluted EPS?

Interpretive response: It depends on whether the instruments are mandatorily convertible at a predetermined date or based on a future condition or event.

— **Predetermined date.** The instrument is included in diluted EPS from the beginning of the period, or the date on which the contract is entered into, if later.

— **Based on a future event or condition.** The instrument is included in diluted EPS by considering the guidance on contingently issuable shares and evaluating the status of the event or condition as of the reporting date, as discussed in section 6.10.

For a discussion of mandatorily convertible instruments at a predetermined date, see sections 3.4.30 and 6.12.20.

Question 4.3.20

Do potential common shares include instruments or contracts that were outstanding during the year but not at year-end?

Interpretive response: Because potential common shares are weighted for the period they are outstanding (see section 4.4.40), identifying potential common shares is not limited to those that remain outstanding at the reporting date. Potential common shares that had been outstanding during the period but were cancelled, allowed to lapse or converted into common shares during the period also need to be identified. [260-10-45-26]

Question 4.3.30

Are contingently convertible securities included in diluted EPS if not currently convertible?

Interpretive response: It depends. Convertible securities include instruments that by their terms may be converted into common shares, such as convertible debt and convertible preferred shares. Their EPS effect depends on the nature of the contingency.

— Instruments that become convertible based on the passage of time or achievement of a defined share price are included in diluted EPS using the if-converted method (see section 4.4) even if the instruments are not currently convertible. An example is an issuer's stock price contingency – also referred to as market contingency. [260-10-45-44]

— Instruments that become convertible upon the occurrence of a specific event other than the issuer's share price are not included until the contingency is resolved. For example, if the instruments are convertible based on achieving a specified earnings target, they are included in diluted EPS if the contingency would be met if the end of the period were also the end of the contingency period (see section 6.10). These instruments are different from mandatorily convertible instruments convertible at a predetermined date (see Question 4.3.10). [260-10-45-44, 45-48b]

Observation#

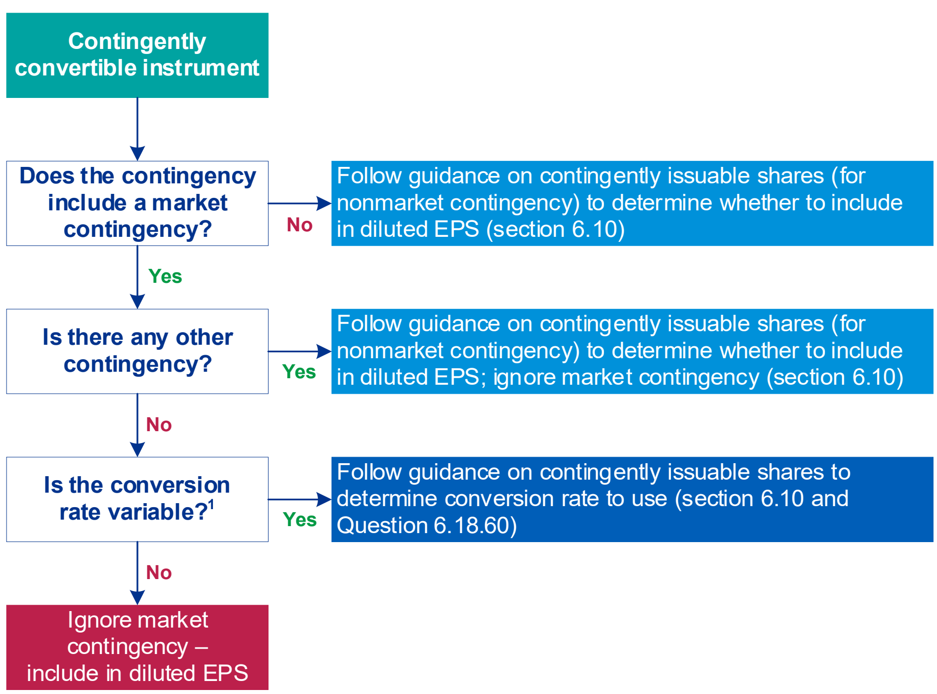
Market contingency in a contingently convertible instrument

A contingently convertible instrument with a market contingency is included in diluted EPS without considering if the market contingency is met. Conversely, if the contingently convertible instrument has both a market contingency and a nonmarket contingency, it is included in diluted EPS only if the nonmarket contingency would be met had the period end been the end of the contingency period. [260-10-45-44]

A contingently convertible instrument with a market condition is treated no differently from a convertible instrument with a market price conversion premium. They are both included in diluted EPS without regard to the market factor. This is because the holder of a convertible instrument would not convert the instrument if the conversion option were out-of-the-money. Therefore, the holder of the instrument is in no different a position from the holder of an instrument that converts only upon a specified market price. [260-10-45-44]

This guidance to ignore the market price contingency in calculating diluted EPS applies only to a contingently convertible instrument (e.g. convertible debt or convertible preferred share) and does not apply to any other contingently exercisable instrument (e.g. option, warrant, RSU).

The following flowchart illustrates how to consider contingently convertible securities in diluted EPS.



Note:

1. In other words, does the rate depend on a future share price, earnings level, or other metric or event?

Question 4.3.40

Can a contingently issuable share ever be included in diluted EPS without determining if the contingency has been met?

Interpretive response: Share-based payment awards that are subject only to a service condition are included in the calculation of diluted EPS because it is assumed that the service condition will be met (see section 6.9). For consideration of share-based payment awards with service conditions and basic EPS, see section 6.9.

Further, contingently convertible securities are included in diluted EPS in accordance with the contingent share guidance. Convertible securities that are subject to market conditions are included in diluted EPS regardless of whether the market condition has been met (see section 6.10.30). [260-10-45-44]

Observation

Contingently issuable shares and share-based payments

Under Topic 718 (stock compensation), when vesting or exercisability is conditional on a target share price or a specified amount of intrinsic value, compensation cost is recognized for employees who remain in service for the requisite period regardless of whether the target share price is actually reached. These awards have market conditions (as defined under Topic 718) and therefore, targeted share price options are not considered to be performance awards under Topic 718.

However, targeted share price options are considered to be contingently issuable shares if the number of shares contingently issuable depends on the market price of the stock *at a future date*, and the calculation of diluted EPS reflects the number of shares that would be issued based on the current market price at the end of the period being reported on if the effect is dilutive. Alternatively, if the condition is based on an average of market prices over a period of time, the average for that period is used. [260-10-45-31, 45-52]

Question 4.3.50

Are instruments that must be settled in cash potential common shares?

Interpretive response: No. Instruments that must be cash-settled are generally not potential common shares and are not included in diluted EPS. However, there may be a dilutive impact to instruments for which the conversion premium may be settled in shares, or when a contract may be settled in cash or shares. See section 6.13.

Question 4.3.60
Are shares in an own-share lending arrangement potential common shares?

Background: An entity may enter into an 'own-share lending arrangement' with a third party, generally an investment bank, in anticipation of a convertible debt offering. As part of the arrangement, the issuer will loan shares to the investment bank to increase the availability of the issuer's shares – to facilitate hedging the conversion feature of the issuer's convertible debt by investors. Question 3.4.20 discusses the effect of own-share lending arrangements on basic EPS.

Interpretive response: No. Because they are expected to be returned, shares subject to an own-share lending arrangement are not considered potential common shares, and therefore are not included in determining diluted EPS.

When default of the share-lending arrangement occurs, the loaned shares are included in the basic EPS calculation, in which case nothing further is added to diluted EPS. [470-20-45-2A]

However, if dividends on the loaned shares are not reimbursable to the entity (i.e. dividends are non-forfeitable) based on the terms of the own-share lending agreement, EPS is calculated using the two-class method (see Question 5.2.150). [470-20-45-2A]

Question 4.3.70
Are redeemable shares considered potential common shares?

Interpretive response: No. However, an entity should distinguish redeemable shares classified in temporary equity (see Question 3.3.20) from mandatorily redeemable preferred shares classified as a liability under Topic 480 (liabilities vs equity) to determine whether there are any EPS considerations.

Mandatorily redeemable preferred shares that are liability-classified are redeemed for cash, and therefore do not affect the EPS denominator (see section 3.4). Similarly, because they will be redeemed for cash, they are not potential common shares and do not affect either basic or diluted EPS. Redeemable shares that are not mandatorily redeemable are generally included in basic EPS (see Question 3.3.30) with no further diluted EPS effect.

Question 4.3.80
Are profits interests potential common shares?

Background: Some pass-through entities grant share-based payments to employees as part of plans that qualify as 'profits interests' for tax purposes. However, this term can be used to refer to a wide range of arrangements, resulting in various compensation structures also referred to as profits interests. Depending on their terms, profits interests may be considered equity interests, and accounted for under Topic 718, or as bonus or profit-sharing arrangements accounted for under Subtopic 710-10.

Interpretive response: It depends on the classification of the profits interests.

— **Bonus or profit-sharing arrangements that are liability-classified** (either as a 710 or 718 award). No effect on EPS, because the compensation expense is recognized in the income statement and cash settlement is presumed.

— **Equity interests** under Topic 718. Potential common shares are included in diluted EPS using the treasury stock method (see sections 4.4.40 and 6.9.40). If the profits interests are entitled to non-forfeitable dividends (see section 5.2), they are participating securities and the two-class method is used for basic EPS, and for diluted EPS if more dilutive than the treasury stock method – see section 5.3.

4.4 Step 2: For each class of potential common shares, determine EPIS

See Appendix A for guidance that applies before adoption of ASU 2020-06.

4.4.10 Overview

The second step to calculating diluted EPS is to determine the 'earnings per incremental share' (or EPIS) for each class of potential common shares, if there is more than one class of potential common shares. Determining EPIS for different classes of potential common shares helps in identifying which of the classes of potential common shares are dilutive and are therefore included in diluted EPS (see section 4.7).

EPIS for a class of potential common shares is determined using the following formula.

Consequential effect on earnings from assumed conversion or exercise of potential common shares (numerator adjustment)	÷	Weighted-average number of outstanding potential common shares (denominator adjustment)	=	EPIS

Section 4.4.30 explains how to determine the numerator adjustment, and section 4.4.40 discusses the denominator adjustment.

Question 4.4.05

Is it always necessary to determine EPIS when there are multiple classes of potential common shares?

Interpretive response: No. Diluted EPS is only calculated if the effect is dilutive considering income from continuing operations (the control number – see section 4.6). If the control number (i.e. income from continuing operations) is a loss, it may not be necessary to calculate diluted EPS because the effect is likely antidilutive.

Whether to determine EPIS, and calculate diluted EPS, when there is a loss from continuing operations depends on the nature of the potential common shares, and whether they would require a numerator adjustment. If an entity's potential common shares are comprised solely of instruments that affect the EPS denominator only (using the treasury stock or reverse treasury stock methods), the result will always be antidilutive. This is because adding more shares when there is a loss dilutes the loss. In such circumstance, EPIS and diluted EPS do not need to be calculated.

However, in some circumstances, instruments included in diluted EPS using the treasury or reverse treasury stock methods do require a numerator adjustment, and then EPIS and diluted EPS should be calculated (regardless of whether there is a loss from continuing operations) because the overall effect of the numerator and denominator adjustments may be dilutive; see sections 4.4.30 and 4.6, and section 6.13. [260-10-45-19]

4.4.20 The if-converted method

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Convertible Securities and the If-Converted Method

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**…

45-41 In applying the if-converted method, conversion shall not be assumed for purposes of computing diluted EPS if the effect would be antidilutive. Convertible preferred stock is antidilutive whenever the amount of the dividend declared in or accumulated for the current period per common share obtainable on conversion exceeds basic EPS. Similarly, convertible debt is antidilutive whenever its interest (net of tax and nondiscretionary adjustments) per common share obtainable on conversion exceeds basic EPS.

When an entity has convertible instruments (e.g. convertible debt and convertible preferred shares) outstanding at any point during the period, the if-converted method is generally used to calculate the dilutive effect on diluted

EPS. The if-converted method assumes that all dilutive potential common shares have been converted into or otherwise resulted in common shares as of the beginning of the period, or from the date the instruments were issued, if later. [260-10-45-40(c)]

Under this assumption, any income, expense or distribution relating to these potential common shares included in income available to common shareholders would not have been recognized. This is because the shareholder cannot share in the income available to a common share and at the same time be entitled to the rights of the original instrument held. For example, interest on a convertible bond would not have been accrued had the bond been converted at the beginning of the period. Accordingly, the numerator is adjusted to reflect any consequential changes in income available to common shareholders that would arise from the assumed conversion of potential common shares (see section 4.4.30). However, if the principal is required to be paid in cash, the entity does not adjust the numerator for the interest. [260-10-45-40(b)]

Consistent with the general premise that diluted EPS includes only those shares that are dilutive, if applying the if-converted method indicates that the effect of an instrument's conversion is antidilutive, conversion is not assumed and any income, expense or distribution is not an adjustment to the income available to common shareholders. [260-10-45-18]

— Convertible preferred shares are antidilutive under the if-converted method if the return (declared or accumulated) for the period on the preferred shares, per common share, is greater than basic EPS. However, an instrument that is dilutive on its own may be antidilutive when considered in sequence with other instruments (see section 4.5).

— Convertible debt is antidilutive under the if-converted method if the interest reversal during the period, per common share, is greater than basic EPS. However, an instrument that is dilutive on its own may be antidilutive when considered in sequence with other instruments (see section 4.5).

The instruments in these two instances are antidilutive because the related earnings are added back to the numerator in calculating diluted EPS, resulting in additional income available to common shareholders. [260-10-45-18, 45-40]

Observation

Antidilution and participating securities

Assumed conversion or exercise of many participating securities (see chapter 5) may be antidilutive because they already receive an allocation of earnings in calculating basic EPS. Therefore, the securities will only be dilutive if their share of earnings is higher assuming conversion or exercise, and this is not offset by the other assumptions inherent in these calculations – e.g. repurchase of common shares with proceeds of exercise for a participating stock option.

4.4.30 Numerator adjustment#

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Computation of Diluted EPS

45-16 … In computing the dilutive effect of convertible securities, the numerator is adjusted in accordance with the guidance in paragraph 260-10-45-40. Adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods.…

• > Convertible Securities and the If-Converted Method

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.
b. If an entity has convertible debt outstanding:
   1. Interest charges applicable to the convertible debt shall be added back to the numerator. For convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator.
   2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.
   3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).
c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator. See paragraph 260-10-45-21A if the incremental shares are variable (such as when calculating a conversion premium).

• > Contracts That May Be Settled in Stock or Cash

45-45 The effect of potential share settlement shall be included in the diluted EPS calculation (if the effect is more dilutive) for an otherwise cash-settleable instrument that contains a provision that requires or permits share settlement (regardless of whether the election is at the option of an entity or the holder, or the entity has a history or policy of cash settlement). An example of such a contract accounted for in accordance with this paragraph and paragraph 260-10- 45-46 is a written call option that gives the holder a choice of settling in common stock or in cash. An election to share settle an instrument, for purposes of applying the guidance in this paragraph, does not include circumstances in which share settlement is contingent upon the occurrence of a specified event or circumstance (such as **contingently issuable shares**). In those circumstances (other than if the contingency is an entity's own share price), the guidance on contingently issuable shares should first be applied, and, if the contingency would be considered met, then the guidance in this paragraph should be applied. Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46, unless the share-based payment arrangement is classified as a liability because of the requirements in paragraph 718-10-25-15 (see paragraph 260-10-45-45A for guidance for those instruments). If the payment of cash is required only upon the final liquidation of an entity, then the entity shall include the effect of potential share settlement in the diluted EPS calculation until the liquidation occurs.

45-45A For a share-based payment arrangement that is classified as a liability because of the requirements in paragraph 718-10-25-15 and may be settled in common stock or in cash at the election of either the entity or the holder, determining whether that contract shall be reflected in the computation of diluted EPS shall be prepared on the basis of the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant guidance of this Topic) if the effect is more dilutive. The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to conclude that the contract will be paid partially or wholly in cash.

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b).

Under the if-converted method, the numerator is adjusted for the after-tax effect of: [260-10-45-40]

- any dividends, interest and other items related to the dilutive potential common shares that are deducted in arriving at the income available to common shareholders; and
- any other changes in income or expense that would result from the assumed conversion of dilutive potential common shares.

However, when the principal of convertible debt is required to be repaid in cash, interest charges are not added back to the numerator (see section 6.13.20).

A numerator adjustment is also made when the accounting classification of an instrument differs from its settlement assumption, even if the instrument is not included in diluted EPS using the if-converted method.

For example, a share-based payment award is liability-classified because it may be settled in cash or shares. The award is included in diluted EPS using the treasury stock method, which includes only a denominator adjustment (see section 4.4.40). However, if share settlement is presumed for EPS purposes, the numerator is also adjusted to reverse the income statement effect of the fair value (mark-to-market) adjustment for the liability-classified award (classified as such for accounting purposes); the instrument would not have been marked to market had it been accounted for as share-settled.

The following table illustrates when instruments generally may require a numerator adjustment.

Classification	Instrument	Numerator adjustment?	Commentary
Equity-classified	**Options and warrants**	✗	Generally, no numerator adjustment.
	Prepaid forward sale contracts	✗	No numerator adjustment.
	Prepaid forward purchase contract or written put option	✗	No numerator adjustment.
Liability-classified	**Options and warrants**	?	Generally, there is a numerator adjustment unless the instrument is a share-based payment award and the share settlement presumption is rebutted. See section 6.13.
	Forward sale contract	✓	Numerator adjustment, as share settlement is either required or it is presumed for EPS. See section 6.13.
	Forward purchase contract or written put option	✓	Numerator adjustment, as share settlement is either required or it is presumed for EPS. See sections 6.13 and 6.15.
Equity- or liability-classified	**Purchased put and call options**	✗	Not included in diluted EPS because doing so would be antidilutive.
	Convertible debt – no embedded derivative	✓	Generally, there is a numerator adjustment (e.g. interest expense); however, it is not made if cash settlement of the principal is required. See section 6.13.
	Convertible debt with embedded derivative	✓	Generally, there is a numerator adjustment (e.g. interest expense, mark-to-market adjustment); however, an interest adjustment is not made if cash settlement is required. See section 6.13.

Question 4.4.10

What is included in the 'interest and other items' numerator adjustment for diluted EPS?

Interpretive response: Interest charges applicable to convertible debt are added back to the numerator of the EPS calculation under the if-converted method – unless the principal of the debt is required to be repaid in cash; this is because these charges would not have been incurred had the debt been converted at the beginning of the period (see note). These charges include interest charges related to the amortization of debt issuance costs, debt discounts or premiums and other yield adjustments. Also included are gains/losses on the extinguishment of debt for those instruments extinguished during the period. A gain/loss for a hypothetical extinguishment on outstanding instruments would not be included in the if-converted method. [260-10-45-40(b)(1)]

'Other items' may also include fair value adjustments. For liability-classified instruments that are share-settled for EPS purposes (i.e. these instruments may be settled in stock or cash), any fair value adjustments that are recognized in income (because the instrument or a related derivative conversion option is recorded at fair value), also result in an adjustment to the numerator. [260-10-55-32, 55-36A]

Examples of numerator adjustments include the following.

Instrument	Numerator adjustments[1]
Convertible debt	— Interest expense recognized during the period for convertible debt for which the principal is settled in, or presumed to be settled in, shares (see section 6.13.30). — Nondiscretionary adjustments[2] recognized during the period. — Mark-to-market adjustment recognized on the convertible debt instrument. — Gains or losses recognized on settlement of convertible debt.
Convertible preferred shares	— Dividends that reduced the numerator during the reporting period, including deemed dividends recognized on the settlement of the preferred share instrument that reduce the numerator. — Nondiscretionary adjustments[2] recognized during the period. — Mark-to-market adjustment recognized on the convertible preferred share instrument.

Notes:

1. Adjustments include the relevant income tax effects.
2. Nondiscretionary adjustments include any expenses or charges that:
   - are calculated on the basis of net income or loss of the period (or similar measure); and
   - would have been calculated differently had the interest expense on the convertible debt never been recognized.

Example 4.4.10
Numerator adjustments for convertible debt

ABC Corp. issues traditional convertible debt that is accounted for as a financial liability using the 'no allocation' method under Topic 470 (debt).

If the convertible debt is dilutive, the relevant adjustments for the debt include:

— the after-tax effect of interest expense that would have been saved from the assumed conversion of the convertible debt – e.g. amortization of initial transaction costs and premiums or discounts accounted for using the effective interest method under Subtopic 835-30 (imputation of interest); see section 6.12 for an illustration of this adjustment;

— the after-tax effect of foreign exchange gain or loss in earnings, if the instrument is denominated in a foreign currency; and

— the after-tax effect of any fair value remeasurement, if ABC elects the fair value option to account for the instrument.

Question 4.4.20
Other than dividend and interest charges, what other adjustments may be made to the numerator in diluted EPS?

Interpretive response: Besides adjusting for dividends and interest on convertible instruments, any other direct changes in income or loss that would result from the assumed conversion of potential common shares are adjusted (see Question 4.4.10). Topic 260 notes that the conversion of potential common shares may lead to consequential changes in earnings, such as profit-sharing expenses. [260-10-45-16, 45-40(b)(2)]

Examples of other consequential effects on income or loss include:

— a decrease in depreciation expense if part of the interest on the debt has been capitalized and is being depreciated under Subtopic 835-20 (capitalization of interest). This is because had the convertible instrument been converted already, there would be no related interest included in depreciation expense; and

— an increase in the expense related to a nondiscretionary employee profit-sharing plan.

We believe that for an item to be treated as having an effect on income as a result of an assumed conversion of dilutive potential common shares, there should be a direct or automatic adjustment to income or loss.

Observation
Interest capitalized during the period

The interest component of depreciation expense that is capitalized as a result of applying the guidance in Subtopic 835-20, is an adjustment to the numerator of diluted EPS (see Question 4.4.20); however, capitalized interest in general is not. This is because interest that is capitalized is not considered an expense or charge during the period to which paragraph 260-10-45-16 applies.

However, an entity considers whether a different amount of interest would have been capitalized on *other* debt had the convertible instruments been converted at the beginning of the period. This can be done by a 'with and without' calculation. If the amount of interest capitalized would have been different if the convertible instrument was not outstanding at the beginning of the period, then interest expense (in the income statement) would also have been different. This difference (between the interest that *was* capitalized and interest that *would have been* capitalized) is a nondiscretionary adjustment to the numerator. [260-10-45-40]

Question 4.4.30
Should inducement costs be removed from the numerator in calculating diluted EPS?

Interpretive response: Yes. Because the if-converted method assumes conversion based on the instrument's existing terms as of the beginning of the period, inducement costs generally would not have been incurred if earlier conversion had occurred.

It is inconsistent to assume conversion as of the beginning of the period and also include an inducement charge in the numerator. Therefore, these costs, which reduce income used in the basic EPS numerator, are reversed (i.e. added back to income) in calculating diluted EPS using the if-converted method.

However, how the inducement costs are removed depends on whether the instrument is equity- or liability-classified.

Equity-classified instruments (including those classified in temporary equity)

Inducement costs recognized on equity-classified convertible preferred shares during the period are treated as a deemed dividend and are deducted from income available to common shareholders when calculating basic EPS (see section 3.3.50). This adjustment is reversed when calculating diluted EPS using the if-converted method.

Liability-classified instruments

Inducement costs for liability-classified instruments are recognized in earnings. Therefore, unlike equity-classified securities, there is no dividend on preferred shares adjustment in the numerator for basic EPS, and no reversal of that adjustment in calculating diluted EPS.

However, in calculating diluted EPS using the if-converted method, expenses and charges recognized in earnings during a period related to the induced conversion of convertible securities (whether liability-classified preferred shares or convertible debt) generally result in an adjustment to the numerator – i.e. they are added back to the numerator to arrive at income available to common shareholders for diluted EPS.

For example, if an entity induces its convertible debt holders to convert through an additional cash payment, the entity adds back the inducement expense to the numerator to calculate its diluted EPS. [260-10-45-16]

Question 4.4.35

How does a redemption or induced conversion of only a portion of outstanding securities affect the numerator in calculating diluted EPS?

Interpretive response: When only a portion of outstanding securities of a given class of securities is redeemed or converted under an inducement offer, to determine whether the if-converted method is dilutive for the period, an entity should: [260-10-S99-2]

— attribute excess consideration (inducement charges) to those securities that it redeems or converts; and

— consider the securities redeemed or converted separately (i.e. those redeemed/converted are a separate class) from those not redeemed or converted.

For example, for an induced conversion the numerator adjustment – i.e. inducement costs that are reversed in the if-converted method (see Question 4.4.30) is allocated to the converted class of securities when determining EPIS (see section 4.4.50).

Example 4.4.20

Other changes in income or loss that would result from an assumed conversion

Scenario 1: Numerator adjustment – consequential effect on employee profit-sharing plan expense

On January 1, Year 1, ABC Corp. issues a bond that is convertible into its common shares; there is no embedded derivative.

— During Year 1, interest expense recognized on the debt is $1,000.
— ABC has a nondiscretionary employee profit-sharing plan that pays 5% of its income before tax annually to all eligible employees.
— All expenses are tax-deductible. The applicable income tax rate is 21%.

Diluted EPS – EPIS numerator adjustment – Year 1

To determine EPIS for the convertible bond, ABC assumes that the bond is converted into common shares at the beginning of Year 1.

With the assumed conversion, the interest on the bond would not have been recognized in Year 1. This would have resulted in an increase in income for Year 1 and would have automatically led to an increase in the employee profit-sharing plan expense.

Diluted EPS

1 Identify potential common shares

The convertible bond represents potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS:

	Before tax	Related tax	After tax
Decrease in interest expense	$1,000	$(210) [$1,000 × 21%]	**$790**
Increase in employee profit-sharing expense	(50) [$1,000 × 5%]	11 [$50 × 21%]	**(39)**
Numerator adjustment	**$950**	**$(199)**	**$751**

Scenario 2: Numerator adjustment – consequential effect on capitalized borrowing costs

On January 1, Year 1, ABC Corp. issues a bond that is convertible into its common shares; there is no embedded derivative.

- During Year 1, ABC recognizes interest on the bond of $9,000, of which $6,000 is recognized in earnings and $3,000 is capitalized into the cost of property, plant and equipment under Subtopic 835-20. There are no other borrowing costs incurred during the period.
- Of the interest of $3,000 capitalized during Year 1, $500 is recognized as part of depreciation expense in Year 1.
- All expenses are tax-deductible. The applicable income tax rate is 21%.

To determine EPIS for the convertible bond, ABC assumes that the bond is converted into common shares at the beginning of Year 1.

With the assumed conversion, the interest on the bond would not have been recognized in Year 1. In addition to the reduction in interest expense, there would have been a reduction in the interest capitalized and therefore a reduction in depreciation expense recognized during Year 1.

Diluted EPS – EPIS numerator adjustment – Year 1

Diluted EPS

1 Identify potential common shares

The convertible bond represents potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS:

	Before tax	Related tax	After tax
Decrease in interest expense	$6,000	$(1,260) [$6,000 × 21%]	**$4,740**
Decrease in depreciation expense	500	(105) [$500 × 21%]	**395**
Numerator adjustment	**$6,500**	**$(1,365)**	**$5,135**

Accordingly, the numerator adjustment is $5,135.

Scenario 3: Numerator adjustment – no consequential effect on income

ABC Corp. issues stock options to its employees. To fulfill its related obligations, ABC writes a call option to Bank Z to purchase its own shares at market price, assuming no liquidity issues for their securities. ABC concludes that this call option is a derivative with a fair value of zero because the call option allows ABC to purchase shares at market price.

Therefore, as far as the call option between ABC and Bank Z is concerned, there will be no impact to earnings; this is because the derivative will always be at fair value and there is no mark to market gain or loss. Accordingly, no numerator adjustment is made to EPIS.

Scenario 4: Numerator adjustment – no consequential effect on income

Continuing Scenario 3, to reduce its exposure to an increase in the market price of its shares when the stock options become exercisable, ABC enters into a share swap with Bank Y.

- ABC takes a notional loan from Bank Y, with the principal amount equal to the purchase price of a notional number of shares at a notional share price.
- ABC pays interest on the notional loan and Bank Y pays dividends on the notional number of shares when ABC declares dividends.
- ABC may change the number of notional shares implicit in the notional loan by notifying Bank Y in advance and intends to reduce the number of notional shares in line with the reduction in options outstanding. The difference between the notional price and the market price of shares is refunded by Bank Y if the number of shares decreases, and vice versa.

Although ABC may intend to adjust the notional amount under the swap arrangement to hedge the share-based payment liability, the adjustment is not automatic and ABC has the discretion to adjust its exposure.

Therefore, we believe there is not sufficient linkage between the swap arrangement with Bank Y and the exercise of options to consider changes in the swap arrangement with Y to be a direct change to income. Accordingly, no numerator adjustment is made to EPIS in this regard.

Question 4.4.40

Is a numerator adjustment made for share-based payment expense?

Interpretive response: It depends. Share-based payments are included in diluted EPS using the treasury stock method, not the if-converted method (see section 4.4.40). We believe the numerator should not be adjusted for equity-settled share-based payment costs when calculating diluted EPS.

A numerator adjustment might be made for liability-classified share-based payment awards under a share-settlement presumption, but a numerator adjustment would not be made for liability-classified awards that are expected to be cash-settled. This is because they are not included in diluted EPS (see section 6.9.20).

Question 4.4.45

Is the income tax effect of numerator adjustments reflected in diluted EPS?

Interpretive response: Yes. The income tax effect of numerator adjustments is reflected in the calculation of EPS. The income tax effect is based on the Topic 740 calculated amount. [260-10-45-40(b)(3)]

Example 4.4.25

Calculation of applicable tax rate for numerator adjustments

ABC is domiciled in the United States and issues bonds that are convertible into its common shares. The bonds may be settled by ABC in any combination of cash or common shares (Instrument X). During the year, interest expense recognized on the debt is $1,000, which is tax deductible.

ABC also has operations in Canada and China that represent approximately 50% of its global sales. The applicable tax rates in the United States, Canada and China are 21%, 26.5% and 25%, respectively.

Because ABC is domiciled in the United States, it calculates the after-tax effect of the interest expense adjustment as $790 under the if-converted method, using the 21% tax rate: $1,000 × (1 - 21%).

4.4.40 Denominator adjustment, including the treasury stock method

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Convertible Securities and the If-Converted Method

45-42 Dilutive securities that are issued during a period and dilutive convertible securities for which conversion options lapse, for which preferred stock is redeemed, or for which related debt is extinguished during a period, shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive convertible securities converted during a period shall be included in the denominator for the period prior to actual conversion. The common shares issued upon actual conversion shall be included in the denominator for the period after the date of conversion. Consequently, shares assumed issued shall be weighted for the period the convertible securities were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

The denominator for diluted EPS is the weighted-average number of common shares used in calculating basic EPS (see section 3.4) plus the number of common shares that would be issued on conversion of all of the dilutive potential common shares into common shares.

Weighted-average number of common shares used in calculating basic EPS (see section 3.4) + Number of common shares that would be issued on conversion of all of the dilutive potential common shares into common shares = **Denominator for diluted EPS**

When determining EPIS for different classes of potential common shares, the shares are weighted for the period they are outstanding. Accordingly, they are included in the denominator for diluted EPS from the beginning of the reporting period, or from the date they are issued if this is later. Potential common shares that were cancelled, allowed to lapse or converted to common shares during the reporting period are included for the period they are outstanding – i.e. until the date on which they were cancelled, lapsed or converted. [260-10-45-42]

Similar to the denominator for basic EPS, when determining the denominator for diluted EPS, strictly speaking, the time-weighting factor is the number of days that the potential common shares are outstanding as a proportion of the total number of days in the period. However, a reasonable approximation is adequate in many circumstances. This might involve using monthly averages, weeks, parts of months or whole months, rather than the precise number of days. [260-10-55-2]

Example 4.4.30
Denominator adjustment – if-converted method

ABC Corp. has the following transactions involving its noncumulative preferred shares during Year 1. All of these preferred shares are convertible into common shares on the same conversion terms; each share of preferred is convertible into one share of common.

Dates in Year 1	Transaction	Preferred shares
January 1	Balance	2,000
April 1	Preferred shares converted into common shares	(500)
July 1	Preferred shares issued	1,000
December 31	**Balance**	**2,500**

Diluted EPS – EPIS denominator adjustment

Diluted EPS

1 Identify potential common shares

The convertible preferred shares represent potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: [Not relevant to this example.]

Potential adjustment to the denominator for EPIS:

	No. of shares outstanding	Time weighting	Weighted-average no. of shares
January 1 – March 31	2,000	3/12	500
April 1 – preferred shares converted	(500)		
April 1 – June 30	1,500	3/12	375
July 1 – preferred shares issued	1,000		
July 1 – December 31	2,500	6/12	1,250
		12/12	
Weighted-average for the year			**2,125**

Therefore, the denominator adjustment for EPS of preferred shares is 2,125.

Denominator adjustment for options, warrants and their equivalents – the treasury stock method

Excerpt from ASC 260-10

• > Options, Warrants, and Their Equivalents and the Treasury Stock Method

45-22 The dilutive effect of outstanding call options and warrants (and their equivalents) issued by the reporting entity shall be reflected in diluted EPS by application of the treasury stock method unless the provisions of paragraphs 260-10-45-35 through 45-36 and 260-10-55-8 through 55-11 require that another method be applied. Equivalents of options and warrants include nonvested stock granted under a share-based payment arrangement, stock purchase contracts, and partially paid stock subscriptions (see paragraph 260-10-55-23). Antidilutive contracts, such as purchased put options and **purchased call options**, shall be excluded from diluted EPS.

45-23 Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. (See paragraphs 260-10-45-29 and 260-10-55-4 through 55-5
c. The incremental shares (the 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.

Example 15 (see paragraph 260-10-55-92) provides an illustration of this guidance. See paragraph 260-10-45-21A if the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument is variable.

• > Average Market Price

55-4 The average market price of **common stock** shall represent a meaningful average. Theoretically, every market transaction for an entity's common stock could be included in determining the average market price. As a practical matter, however, a simple average of weekly or monthly prices usually will be adequate.

55-5 Generally, closing market prices are adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the high and low prices for the period that the price represents usually would produce a more representative price. The method used to compute the average market price shall be used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to compute the average market price for several years of relatively stable market prices might need to change to an average of high and low prices if prices start fluctuating greatly and the closing market prices no longer produce a representative average market price.

In addition to the general principles described so far in this chapter, specific requirements apply when determining the denominator adjustment for different types of potential common shares. For example, for options, warrants and their equivalents, rather than simply adding to the denominator the weighted-average number of common shares to be issued from the assumed conversion of the options, Topic 260 prescribes another method – the treasury stock method.

Under the treasury stock method, the proceeds from the instrument's exercise are assumed to be used to repurchase common shares at the average market price during the period, and only the incremental shares (excess of the shares issued on exercise less the shares repurchased) are included in the denominator.

The following diagram summarizes the treasury stock method for instruments other than those issued in share-based payment arrangements.

The treasury stock method		
Step i	**Calculate the assumed proceeds** Calculate the proceeds that would have been received from the assumed exercise of all options.	'Exercise price' **x** number of options
Step ii	**Calculate the incremental shares deemed to be repurchased at average market price** Calculate the number of common shares that would have been repurchased if the proceeds received in Step (i) were used to acquire these shares at their average market price during the period.	Assumed proceeds ÷ average market price of shares
Step iii	**Determine the incremental shares** Calculate the difference between the number of common shares that would be issued at the exercise of the options and the number of common shares deemed to be repurchased at the average market price.	Number of shares that would be issued – number of shares deemed to be repurchased

The denominator in the year-to-date period is calculated using an average of the quarterly denominators, as discussed in section 8.3.30.

For further discussion of the treasury stock method, see section 6.9.30. For further discussion of how the treasury stock method is applied to share-based payment arrangements, see section 6.9.50.

In applying the treasury stock method to awards accounted for under Topic 718, the awards may be antidilutive even when the market price of the underlying share exceeds the related exercise price. This is because compensation cost attributed to future services and not yet recognized is included as a component of assumed proceeds in applying the treasury stock method.

In addition to the treasury stock method, there is also the reverse treasury stock method (see section 6.15.30). These two methods are used to calculate the effect on diluted EPS for the following instruments.

Instrument	Method	Discussion
Partially paid common shares	Treasury stock method	Section 6.3
Unvested common shares	Treasury stock method	Section 6.8
Written put options	Reverse treasury stock method	Section 6.15
Written call options ('options')	Treasury stock method	Section 6.9
Written forward purchase contracts	Reverse treasury stock method	Section 6.15
Written forward sale contracts	Treasury stock method	Section 6.9.

For further discussion of the denominator adjustment for other specific types of potential common shares, see chapter 6.

Question 4.4.50

How is the average market price of common shares determined when applying the treasury stock method?

Interpretive response: The average market price is determined based on:

— the full reporting period; or
— the period for which the options are outstanding if this is shorter (see section 6.9).

For example, if the options are outstanding only for six months of the reporting period, in determining the incremental shares the average market price is based on the average market price during that six-month period.

An entity that has multiple issuances of the same instrument during the period performs a separate average market price calculation for each issuance. This is because the instruments were outstanding for different time periods during the reporting period, and the share prices may have been different during those periods. However, when an entity only has one instrument, it may apply a weighted-average approach to calculate the number of potential common shares outstanding and then apply the average market price of the shares for the entire period the instruments were outstanding. See Example 4.4.35.

For entities that report quarterly information, see section 8.3.30 for guidance on year-to-date calculations.

Quoted market prices available

When determining the average market price for a period, in theory every market transaction could be included. However, as a practical matter a simple average of weekly or monthly prices is usually adequate. [260-10-55-4]

While closing market prices are generally adequate for calculating the average market price, when the share price fluctuates widely, the closing price may not be an appropriate representation. In that case, a daily average (not merely a simple average) of the high and low prices is usually more representative.

However, we believe an entity should not consider pre- or post-market trading when calculating the average share price. [260-10-55-5]

When an entity's shares are not actively traded, we believe it may be appropriate to use the average of the bid and ask prices because there is less market activity for the shares.

The method used to calculate the average market price is used consistently unless it is no longer representative because conditions have changed. For example, if an entity uses closing market prices to calculate the average market price for several years, but prices then start fluctuating significantly, it might need to change to an average of high and low prices. [260-10-55-5]

Quoted market prices not available

In some cases, there may not be a quoted market price for the common shares for the full period. For example, this may be the case if the entity does not have common shares or potential common shares that are publicly traded but the entity elects to disclose EPS, or if the entity's common shares or potential common shares were not listed for the full period.

For example, an entity with an annual reporting period ending on December 31, Year 1 lists its common shares on November 7, Year 1, so that it has a quoted market price for its shares only during the period from November 7 – December 31, Year 1.

We believe that if the average market price of the shares is necessary to calculate diluted EPS (e.g. because the entity has outstanding warrants or options for the entire year), the average market price used should be a meaningful average for the full reporting period, or the period for which the potential common shares are outstanding if this is shorter.

We do not believe that an average market price for approximately two months in the above example would be meaningful for potential common shares outstanding for the full year.

Further, we believe that if there is no active market for common shares, the entity should determine fair value using valuation techniques. We believe that an entity should apply the guidance in Topic 820; see KPMG Handbook, Fair value measurement. The use of a valuation professional may be required in this assessment. Also, an entity should consider valuations made for other purposes, such as for share-based payment grants, and the consistency of inputs and methods used.

The method used to determine the average market price is disclosed in the notes to the financial statements. [235-10-50-3, SEC FRM 9520.1]

Question 4.4.55

How is the average market price of common shares determined when there is a spinoff?

Interpretive response: Certain transactions, such as a spinoff, may result in a change in the fair value of the market price. An entity does not adjust historical market prices to reflect the effect of any changes from the spinoff transaction (i.e. as if the transaction had occurred in a prior period). Therefore, historical average market prices, when applying the treasury stock method, are not adjusted as if the transaction had occurred in a prior period. [260-10-45-21]

Example 4.4.35

Weighted-average potential common shares – treasury stock method

On January 1, ABC Corp. has 2,000 stock options outstanding. On April 1,500 stock options were exercised, and on July 1 an additional 1,000 stock options were granted.

The stock options all have the same terms, and ABC performs the treasury stock method considering the various stock option issuances as one class of potential common shares. It calculates a weighted-average number of instruments outstanding during the year as follows.

	No. of shares outstanding	Time weighting	Weighted-average no. of shares
January 1 – March 31	2,000	3/12	500
April 1 – stock options exercised	(500)		
April 1 – June 30	1,500	3/12	375
July 1 – stock options granted	1,000		
July 1 – December 31	2,500	6/12	1,250
		12/12	
Weighted average for the year			**2,125**

Therefore, ABC includes 2,125 stock options in its treasury stock method calculation.

Observation#

Stock options and warrants that are out-of-the-money

Stock options or warrants that are out-of-the-money from the holder's perspective at the reporting date are not assumed to be exercised for purposes of applying the treasury stock method. These instruments are not included in diluted EPS, and it is not necessary to determine if they are dilutive or not until they are in-the-money. This is because, under the treasury stock method, the proceeds from the assumed exercise of the instruments are used to repurchase the shares at the average market price, and only the incremental (i.e. remaining) shares are added to the denominator (see Example 4.4.50). If the exercise price is greater than average market price, there are no incremental shares to add to the denominator, meaning there is no dilution.

An option or warrant that is uneconomical from the holder's perspective, i.e. out-of-the-money based on the *period-end price*, might still be dilutive and included in diluted EPS. This is because 'in-the-money' from a Topic 260 perspective is determined by comparing the average share price to the exercise price. Similarly, the treasury stock method uses the average market price for the year (or period of time the instrument is outstanding, if shorter). As long as the average market price is higher than the exercise price, the instrument is dilutive, regardless of whether the share price at the end of the reporting period is higher or lower than the exercise price.

The same applies to share-based payment awards in the form of options and unvested shares. [260-10-45-25, 45-28A]

Section 6.9.20 discusses when options and warrants, including share-based payment awards, are in-the-money.

Example 4.4.40
Average share price before IPO

ABC Corp. completes an initial public offering (IPO) on June 1 and can measure the fair value of its shares from June 1 through December 31. However, ABC has difficulty determining its average market price before the IPO.

In applying the treasury stock method, ABC cannot assume that the IPO price is the average market price from January 1 through May 31. If ABC had obtained a stock option price valuation the previous June, it should review that report to determine a meaningful average market price. ABC should update the valuation report for changes in the price of its shares up to the IPO date.

Note: A nonpublic entity should look at valuation reports when measuring compensation or facilitating business combinations to develop meaningful average prices for periods in which its shares were not publicly traded.

Example 4.4.50
Treasury stock method calculation for options and warrants

ABC Corp. previously issued an equity-classified warrant in a financing transaction that allows the holder to purchase 10,000 common shares of ABC stock at $54 per share. The average market price of ABC's common stock during the reporting period is $60 and the warrant is outstanding throughout the period.

ABC assumes exercise of the warrants and issuance of 10,000 shares of common stock for the treasury stock calculation. The $540,000 that ABC would realize from exercise of the warrant ($54 × 10,000) is sufficient to repurchase 9,000 shares of its common stock ($540,000 ÷ $60) based on the average price of ABC common shares during the period. Therefore, ABC adds 1,000 incremental shares (10,000 – 9,000) to the denominator when calculating diluted EPS for the period.

Note: This method applies to written call options and warrants that allow the investor to purchase an entity's common shares in exchange for cash or other assets – or that do not require additional transfer of consideration, such as restricted shares. Certain adjustments are necessary for other types of options (see section 6.9).

Multiple conversion or exercise bases

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Conversion Rate or Exercise Price

45-21 Diluted EPS shall be based on the most advantageous **conversion rate** or **exercise price** from the standpoint of the **security** holder. Previously reported diluted EPS data shall not be retroactively adjusted for subsequent conversions or subsequent changes in the market price of the common stock.

• > Variable Denominator

45-21A Changes in an entity's share price may affect the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument. For example, when the principal of a convertible debt instrument is required to be settled in cash but the conversion premium is required to (or may) be settled in shares, the number of shares to be included in the diluted EPS denominator is affected by the entity's share price. In applying both the treasury stock method and the if-converted method of calculating diluted EPS, the average market price shall be used for purposes of calculating the denominator for diluted EPS when the number of shares that may be issued is variable, except for contingently issuable shares within the scope of the guidance in paragraphs 260-10-45-48 through 45-57. See paragraphs 260-10-55-4 through 55-5 for implementation guidance on determining an average market price.

• > Contracts That May Be Settled in Stock or Cash

45-45 The effect of potential share settlement shall be included in the diluted EPS calculation (if the effect is more dilutive) for an otherwise cash settleable instrument that contains a provision that requires or permits share settlement (regardless of whether the election is at the option of an entity or the holder, or the entity has a history or policy of cash settlement). An example of such a contract accounted for in accordance with this paragraph and paragraph 260-10- 45-46 is a written call option that gives the holder a choice of settling in common stock or in cash. An election to share settle an instrument, for purposes of applying the guidance in this paragraph, does not include circumstances in which share settlement is contingent upon the occurrence of a specified event or circumstance (such as **contingently issuable shares**). In those circumstances (other than if the contingency is an entity's own share price), the guidance on contingently issuable shares should first be applied, and, if the contingency would be considered met, then the guidance in this paragraph should be applied. Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46, unless the share-based payment arrangement is classified as a liability because of the requirements in paragraph 718-10-25-15 (see paragraph 260-10-45-45A for guidance for those instruments). If the payment of cash is required only upon the final liquidation of an entity, then the entity shall include the effect of potential share settlement in the diluted EPS calculation until the liquidation occurs.

45-45A For a share-based payment arrangement that is classified as a liability because of the requirements in paragraph 718-10-25-15 and may be settled in common stock or in cash at the election of either the entity or the holder, determining whether that contract shall be reflected in the computation of diluted EPS shall be prepared on the basis of the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant guidance of this Topic) if the effect is more dilutive. The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to conclude that the contract will be paid partially or wholly in cash.

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b).

• • > Options and Warrants and Their Equivalents

55-8 When several conversion alternatives exist, the computation shall give effect to the alternative that is most advantageous to the holder of the convertible security. Similar treatment shall be given to **preferred stock** that has similar provisions or to other securities that have conversion options that permit the investor to pay cash for a more favorable **conversion rate**.

Some types of potential common shares have more than one basis of conversion – e.g. the manner of conversion is at the discretion of one of the contracting parties, or the conversion rates or exercise prices vary over time. When determining the effect of these potential common shares on diluted EPS, the general principle is that the diluted EPS should capture the maximum dilutive effect arising from potential common shares outstanding during the period. This generally means the following.

— **Contracts whose conversion rate or exercise price varies over time.** Use the most advantageous conversion rate or exercise price, from the standpoint of the holder of the potential common shares, that is available to the holder for the remainder of the contract. [260-10-45-21]

— **Contracts with conversion alternatives.** If the holder has an advantage by choosing one conversion alternative over another (e.g. a more favorable conversion rate if the investor pays cash), the alternative that is more advantageous to the holder is assumed. [260-10-55-8]

— **Contracts that may be settled in common shares or cash (regardless of who can choose how to settle).** Assume the contract will be settled in common shares. See section 6.13. [260-10-45-45 – 45-46]

When the conversion rate or exercise price is affected by the entity's share price and the number of shares that may be issued is variable, the average market price is used when determining the effect of the shares on diluted EPS, unless it is a contingently issuable potential common share (see section 6.11 and Question 6.12.25). When the conversion rate or exercise price assumed in the EPS calculation varies between the periods presented, previously reported EPS amounts are not adjusted to reflect the change. [260-10-45-21, 45-21A]

For further guidance and examples on how the conversion options affect diluted EPS, in addition to the questions below, see sections 6.12 and 6.13.

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Question 4.4.60

What conversion rate is used for convertible instruments (share-settled) when the rate is based on the market price?

Background: An entity may have outstanding convertible preferred shares or convertible debt that is required to be exchanged for a variable number of common shares based on the market price of the entity's common shares on a specific date for a fixed monetary amount (share-settled instruments).

Interpretive response: In applying the if-converted method to instruments with a variable conversion price or exchange ratio based on the market price, in general an entity should use the average market price for the period to determine the price or exchange ratio. This is referred to as the variable denominator guidance. However, if an entity believes that the contingently issuable shares guidance applies, the number of shares the entity will issue is calculated using the guidance in paragraphs 260-10-45-48 and 45-52 (see section 6.10). Further, an entity cannot project future share prices. [260-10-45-21A]

Which guidance applies - the contingently issuable shares guidance or the variable denominator guidance - is not always clear. Therefore, judgment may need to be applied, considering the terms of the contract. Based on our informal discussions with the FASB staff, paragraph 260-10-45-21A (which was introduced by ASU 2020-06) was not intended to change the application of the contingently issuable shares.

Question 4.4.70

What exercise price is used when the exercise price is based on the common share market price?

Background: Some agreements establish the exercise price of the instrument as a percentage of the average market price over a specified number of days (e.g. a 20-day VWAP prior to exercise).

Interpretive response: In applying the treasury stock method to calculate diluted EPS, an entity calculates the number of potential common shares to be added to the denominator using the average market price during the period, unless the guidance on contingently issuable shares applies. [260-10-45-21A]

Some entities use a market price formula, specifying as the market price input the average of the prices for a specified period immediately preceding the period end. This methodology is consistent with the guidance on contingently issuable shares, which states that diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period, or average for that period, if applicable, if the effect is dilutive (see section 6.10). However, an entity cannot project future share prices. [260-10-45-52]

Which guidance applies - the contingently issuable shares guidance or the variable denominator guidance - is not always clear. Therefore, judgment may need to be applied, considering the terms of the contract. Based on our informal discussions with the FASB staff, paragraph 260-10-45-21A (which was introduced by ASU 2020-06) was not intended to change the application of the contingently issuable shares guidance.

Question 4.4.80

Does diluted EPS consider potential changes to the conversion rate or exercise price that are contingent on changes in the market or future events?

Interpretive response: No. We believe that only changes to the conversion rates or exercise price that are available solely due to the passage of time should be considered in diluted EPS, and the conversion rate or exercise price that is most advantageous to the holder should be used. [260-10-45-21, 55-8]

If the conversion rate or exercise price is based on a market price, the average market price during the period is used. See Questions 4.4.60 and 4.4.70. [260-10-45-21A]

Changes that are contingent on the occurrence or nonoccurrence of a future event, such as a secondary offering or a change of control, are only considered when the event actually occurs. [260-10-45-48]

If changes are contingent upon the satisfaction of a condition (i.e. a specified market price or earnings target), the guidance on contingently issuable shares applies. See sections 6.10 and 6.11, and Question 4.4.90. [260-10-45-48]

Question 4.4.90

What number of shares is used when the number of shares is variable?

Interpretive response: When the number of shares to be issued is variable, based only on the passage of time, we believe an entity should analogize to the guidance in paragraph 260-10-45-21 and uses the number of shares that is most advantageous to the holder for the remainder of the contract. For example, if the entity issues bonds that are convertible into 100 shares after one year, and 150 shares after two years, the entity considers 150 shares when calculating diluted EPS.

Alternatively, if the number of shares is variable based on the occurrence or nonoccurrence of a future event, or the satisfaction of a condition (i.e. a specified market price or earnings target), the guidance on contingently issuable shares applies. See sections 6.10 and 6.11, and Question 4.4.80. [260-10-45-21, 45-48, 55-8]

Observation

Number of shares to be issued vs number of shares to be included in diluted EPS under the treasury stock method

When the *number of shares to be issued* is variable, Topic 260 requires an entity to use the average share price. However, if there are different conversion or exercise alternatives, the entity uses the most advantageous share price to the holder – or, if based on a contingency, the share price relevant to the status of the contingency – to determine the number of shares to be issued (see Question 4.4.90). However, in the treasury stock method calculation to determine the *incremental shares* to be included in diluted EPS, the average share price is always used. [260-10-45-21, 45-21A, 45-23]

Question 4.4.100

How does an exercise or conversion price adjustment based on future dividends affect diluted EPS?

Interpretive response: It depends on whether the adjustment is based on actual dividends declared or if it is a predefined adjustment that is intended to account for future anticipated dividends. If the adjustment is based on actual dividends, the instrument may be a participating security (see Question 5.2.50). However, an entity should not project future dividends.

Changes in the number of potential common shares outstanding without corresponding changes in capital resources

Similar to the denominator for basic EPS (see sections 3.4 and 6.2), the denominator for diluted EPS may be affected if the number of potential common shares outstanding increases or decreases without a corresponding change in capital resources – e.g. as a result of a stock dividend, stock split or reverse stock split.

Many types of potential common shares contain antidilution provisions that protect their holders from devaluation of their rights. For example, the terms of a stock option may specify that its conversion ratio be adjusted in the event of a stock split. If there is a change in the number of outstanding common shares without a corresponding change in capital resources, the terms of potential common shares outstanding at the time of the change are evaluated to determine whether there is a corresponding change in the number of potential common shares outstanding and therefore a corresponding adjustment to the denominator for the diluted EPS calculation. In such situations, EPS is retrospectively adjusted for all periods presented (see section 7.2.20).

4.4.50 Determining EPIS

Once the adjustments to the numerator and the denominator have been determined, EPIS is calculated using the formula in section 4.4.10.

Question 4.4.110
Can instruments be combined when calculating EPIS (and sequencing)?

Interpretive response: Yes, if they are of the same class (i.e. with the same terms) and have been outstanding for the same period of time.

Example 4.4.60
Determining EPIS

Consider the same fact pattern as presented in Example 4.4.30. The following additional facts are relevant.

— The convertible bonds are classified as liabilities. During Year 1, the interest expense on the convertible bonds is $1,000. Upon conversion, 2,125 common shares would be issued.

— All expenses are tax-deductible. The applicable income tax rate is 21%.

Diluted EPS – EPIS calculation – Year 1

Diluted EPS

1 Identify potential common shares

The convertible bonds represent potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS:

	Before tax	Related tax	After tax
Decrease in interest expense	$1,000	$(210) [$1,000 × 21%]	$790
Numerator adjustment			$790

Potential adjustment to the denominator for EPIS: 2,125 (see Example 4.4.30).

EPIS = $790 ÷ 2,125 = **$0.37**

4.5 Step 3: Rank potential common shares based on EPIS

Excerpt from ASC 260-10

• > No Antidilution

45-18 Convertible securities may be dilutive on their own but antidilutive when included with other potential common shares in computing diluted EPS. To reflect maximum potential dilution, each issue or series of issues of potential common shares shall be considered in sequence from the most dilutive to the least dilutive. That is, dilutive potential common shares with the lowest earnings per incremental share shall be included in diluted EPS before those with a higher earnings per incremental share. Example 4 (see paragraph 260-10-55-57) illustrates that provision. Options and warrants generally will be included first because use of the treasury stock method does not affect the numerator of the computation…

Step 3: Rank potential common shares

More than one class of potential common shares	Rank potential common shares from the lowest to the highest EPIS. Potential common shares with adjustments only to denominator are included first

When determining diluted EPS, it is necessary to establish whether an entity's potential common shares are dilutive. They are dilutive if the assumed conversion of the potential common shares decreases income from *continuing operations* per share. Income from continuing operations is used as the 'control number' (see section 4.6).

If an entity has more than one class of potential common shares, dilution is judged by the cumulative impact of potential common shares. Because the objective of diluted EPS is to reflect the maximum dilutive effect taking into account all of an entity's potential common shares, the effects of any antidilutive potential common shares are ignored.

Determining the cumulative impact of potential common shares requires the shares to be ranked, which is Step 3 of the five-step analysis. The following summarizes how Steps 1 – 3 fit together.

— Each class of potential common shares identified in Step 1 is considered in sequence from the most dilutive to the least dilutive.

— To work out this sequence, Step 2 determines EPIS for each class of potential common shares.

— Step 3 ranks the classes of potential common shares in order from the most dilutive (the class with the lowest EPIS) to the least dilutive (the class with the highest EPIS).

— Under Step 3, classes of potential common shares that have denominator adjustments but do not have numerator adjustments are ranked the most dilutive starting with the class that results in the greatest number of bonus shares. An example of these instruments is an equity-classified stock option (see section 6.9).

After the potential common shares are ranked, they are added to the diluted EPS calculation one by one, in sequence, stopping when a class of potential common shares has an antidilutive effect. This ensures that only dilutive potential common shares are included in diluted EPS. See section 4.7 (Step 5).

Example 4.5.10
Ranking potential common shares based on EPIS

ABC Corp. had the following potential common shares outstanding during the year.

— Option to buy 5,000 common shares at $8 per share.

— Convertible debt (3% yield) with a principal amount of $5,000,000 (issued at par). Debt is convertible into 20 common shares per $10,000.

— Convertible preferred shares (1,000,000 shares) entitled to a cumulative dividend of $4 per share. Each preferred share is convertible into two common shares.

The following additional information is relevant.

— Average market price of ABC's common shares is $10.
— All expenses are tax deductible.
— Applicable income tax rate is 21%.

Diluted EPS – EPIS calculation

Diluted EPS

1 Identify potential common shares

The options, convertible debt and convertible preferred shares represent potential common shares.

2 For each potential common share, calculate EPIS

	Increase in available income	Increase in number of common shares	EPIS[6]
Options	–	1,000[1]	–
Convertible debt	$118,500[2]	10,000[3]	$11.85
Convertible preferred shares	$4,000,000[4]	2,000,000[5]	$2.00

Notes:

1. ($10 average market price – $8 option price) ÷ $10) × 5,000 options outstanding.
2. ($5,000,000 principal amount × 3% interest) × (1 – 21% income tax rate).
3. ($5,000,000 principal ÷ 10,000) × 20 common shares.
4. 1,000,000 preferred shares × $4 dividend per share.
5. 1,000,000 preferred shares × 2 common shares.
6. (Increase in available income) ÷ (Increase in number of common shares).

3 Rank the potential common shares

The potential common shares are ranked in the following order (from most to least dilutive):

— options
— convertible preferred shares
— convertible debt.

Note that the options are the most dilutive (while having a $0 EPIS) as the options are potential common shares that have a denominator adjustment but do not have a numerator adjustment. Example 4.7.10 continues with this fact pattern to identify dilutive instruments and determine diluted EPS.

4.6 Step 4: Determine basic EPS from continuing operations (the control number)

Excerpt from ASC 260-10

• > No Antidilution

45-18 …An entity that reports a discontinued operation in a period shall use income from continuing operations (adjusted for preferred dividends as described in paragraph 260-10-45-11) as the control number in determining whether those potential common shares are dilutive or antidilutive. That is, the same number of potential common shares used in computing the diluted per-share amount for income from continuing operations shall be used in computing all other reported diluted per-share amounts even if those amounts will be antidilutive to their respective basic per-share amounts. (See paragraph 260-10-45-3.) The control number excludes income from continuing operations attributable to the noncontrolling interest in a subsidiary in accordance with paragraph 260-10-45-11A. Example 14 (see paragraph 260-10-55-90) provides an illustration of this guidance.

45-19 Including potential common shares in the denominator of a diluted per-share computation for continuing operations always will result in an antidilutive per-share amount when an entity has a loss from continuing operations or a loss from continuing operations available to common stockholders (that is, after any preferred dividend deductions). Although including those potential common shares in the other diluted per-share computations may be dilutive to their comparable basic per-share amounts, no potential common shares shall be included in the computation of any diluted per-share amount when a loss from continuing operations exists, even if the entity reports net income.

45-20 The control number for determining whether including potential common shares in the diluted EPS computation would be antidilutive should be income from continuing operations (or a similar line item above net income if it appears on the income statement). As a result, if there is a loss from continuing operations, diluted EPS would be computed in the same manner as basic EPS is computed, even if an entity has net income after adjusting for a discontinued operation. Similarly, if an entity has income from continuing operations but its preferred dividend adjustment made in computing income available to common stockholders in accordance with paragraph 260-10-45-11 results in a loss from continuing operations available to common stockholders, diluted EPS would be computed in the same manner as basic EPS.

Step 4: The 'control number'

Income (loss) from continuing operations available to common shareholders	=	The control number

Topic 260 uses income from *continuing* operations available to common shareholders as the 'control number' in determining whether potential common shares are dilutive or antidilutive.

The following items are excluded from the control number: [260-10-45-18]

— items relating to discontinued operations under Subtopic 205-20; and
— income from continuing operations attributable to NCI.

Question 4.6.02

Which income is used as the control number when there is NCI?

Interpretive response: When an entity has NCI, income from continuing operations attributable to the parent is used as the control number in determining whether potential common shares are dilutive. [260-10-45-18]

Question 4.6.05

How is diluted EPS affected when there is a loss from continuing operations (the control number)?

Interpretive response: When the control number is a loss, adding shares to the denominator dilutes the loss per share. This is antidilutive to EPS – a dilution of loss per share effectively results in an increase to EPS. Therefore, generally when the control number is a loss, potential common shares are not added to calculate diluted EPS because they are antidilutive (but see Questions 4.4.05 and 4.6.10). [260-10-45-19]

For example, when the control number is a loss, in the simplest case, stock options are antidilutive because under the treasury stock method there is no change to the numerator, yet the potential shares resulting from exercise of the options are added to the denominator. This reduces the loss per share, effectively resulting in an increase to EPS. These potential common shares are antidilutive and are ignored in diluted EPS. This is regardless of whether the potential common shares are dilutive for EPS from net income.

The same concept applies if there is income from continuing operations, but the effect of adjustments to the EPS numerator to arrive at income from continuing operations available to common shareholders results in a loss. Even though there is income from continuing operations, adding the potential common shares may be antidilutive.

Question 4.6.08
How does using the control number affect the various measures of diluted EPS?

Interpretive response: The following table illustrates the concept of using income from continuing operations as the control number in various income and loss scenarios. The table assumes that the net effect of all potential common shares is to reduce earnings per share or increase loss per share.

Scenario		Present diluted EPS from		
		Continuing operations	Discontinued operations	Net income
Income from continuing operations	Same as net income	n/a	n/a	✔
	Income from discontinued operations	✔	✔	✔
	Loss from discontinued operations and net income	✔	✔	✔
	Loss from discontinued operations and net loss	✔	✔	✔
Loss from continuing operations[1]	Same as net loss	n/a	n/a	✘
	Loss from discontinued operations	✘	✘	✘
	Income from discontinued operations and net loss	✘	✘	✘
	Income from discontinued operations and net income	✘	✘	✘

Note:
1. See Question 4.6.10.

Observation

Using the control number facilitates EPS comparability

Using the control number to determine which potentially dilutive shares to include in diluted EPS results in the same number of shares used in all EPS measures – i.e. from continuing operations, discontinued operations and net income. The antidilution sequencing (see sections 4.5 and 4.7) is performed against only the control number (income from continuing operations). This facilitates comparability because the number of shares used remains constant among the different EPS measures.

Question 4.6.10

Can a potential common share ever be included in diluted EPS when there is a loss from continuing operations (the control number)?

Interpretive response: Yes. Some interpret the guidance in paragraph 260-10-45-19 to mean that under no circumstance should an entity include potential common shares in diluted EPS in periods when the entity reports a loss from continuing operations. However, we believe this guidance does not contemplate that an instrument (e.g. a warrant) that is in-the-money (see paragraph 260-10-45-25) and classified as an asset or liability under Subtopics 480-10 (debt versus equity) or 815-40 (contracts in own equity) may be dilutive.

Some instruments that are assets or liabilities are measured at fair value (i.e. marked to market) during the period, resulting in changes to income that reflect the changes in fair value of the instruments. If the fair value change during the period for this type of instrument is a gain, the instrument could be dilutive. This is because the gain is reversed in the numerator, which may create a loss and a dilutive loss per share when the additional shares are factored into the denominator. Therefore, while most instruments are antidilutive in periods that the entity reports a loss from continuing operations, an entity includes an instrument in diluted EPS if the effect of the numerator and denominator adjustments is dilutive. For further discussion, see section 6.13 and Question 6.13.10.

Example 4.6.10
Dilutive or antidilutive – the 'control number'

The following is Parent's income (loss) for Years 1 to 3.

	Year 1	Year 2	Year 3
Income (loss) from continuing operations	$5,000,000	$ 1,000,000	$(1,000,000)
Income (loss) from discontinued operations	(3,000,000)	(3,000,000)	3,000,000
Net income (loss)	**$2,000,000**	**$(2,000,000)**	**$ 2,000,000**

The weighted-average number of Parent's outstanding common shares throughout the three years is 200,000 shares.

As part of the acquisition of Subsidiary, before Year 1 Parent entered into an agreement with the former shareholders of Subsidiary to issue 20,000 common shares for no further consideration in September, Year 4 if the market price of Parent's common shares is above $15 at that date. At each of December 31, Year 1, Year 2 and Year 3, the market price of Parent's common shares is above $15.

Dilutive or antidilutive?

The treatment of contingently issuable common shares is discussed in more depth in section 6.10; see also section 4.4.

Although Parent would not issue any common shares under its agreement with Subsidiary's former shareholders until the specified market price target is met in Year 4, the agreement gives rise to potential common shares that result in an adjustment to diluted EPS if they are dilutive.

In evaluating whether the assumed conversion decreases EPS from continuing operations in Years 1 to 3, Parent assumes that the 20,000 contingently issuable common shares are outstanding common shares in each of the years.

5 Identify dilutive potential common shares and determine diluted EPS

The contingently issuable common shares are initially considered dilutive because no adjustment to the numerator for EPIS is required. However, in Year 3, the overall result is antidilutive because of the loss from continuing operations (the control number) in that year.

	Year 1	Year 2	Year 3
Basic EPS:			
From continuing operations (the control number)	$25 [$5,000,000 ÷ 200,000]	$5 [$1,000,000 ÷ 200,000]	$(5) [($1,000,000) ÷ 200,000]

	Year 1	Year 2	Year 3
Diluted EPS:			
From continuing operations (the control number)	$22.73 5,000,000 ÷ 220,000]	$4.55 [$1,000,000 ÷ 220,000]	$(4.55) [$(1,000,000) ÷ 220,000]
Dilutive?	✓	✓	✗

Therefore, the following is diluted EPS from continuing operations and net income:

	Year 1	Year 2	Year 3
From continuing operations	$22.73	$4.55	$(5.00)
From net income	$9.09 [$2,000,000 ÷ 220,000]	$(9.09) [$(2,000,000) ÷ 220,000]	$10.00 [$2,000,000 ÷ 200,000]

This example illustrates the 'control number' notion: once certain potential common shares are regarded as dilutive for a reporting period because they reduce EPS from continuing operations, they are included in the denominators for all diluted EPS measures for that period.

For example, Parent includes 20,000 potential common shares in its diluted EPS from continuing operations in Year 2 because the resulting amount is dilutive – i.e. the inclusion reduces the EPS from continuing operations from $5 to $4.55. Therefore, Parent includes the same 20,000 potential common shares in its diluted loss per share from total operations in Year 2, even though the resulting amount is antidilutive to the comparable basic loss per share amount for net income – i.e. the inclusion reduces the loss per share from $10 to $9.09.

In contrast, in Year 3 the 20,000 shares are not included in diluted EPS because they are not dilutive for continuing operations, even though they would be for total operations – i.e. the inclusion would reduce the EPS from total operations from $10 to $9.09.

Question 4.6.15

Can diluted EPS ever be greater than basic EPS?

Interpretive response: Yes, when an entity has income from continuing operations, a loss from discontinued operations, and net income is less than income from continuing operations (or net loss is greater than net loss from continuing operations).

Because income from continuing operations is the control number, an entity calculates diluted EPS even though there is a loss from discontinued operations (and an overall net loss, if applicable) and adding shares to the denominator is antidilutive to EPS from discontinued operations (and overall EPS) (see Question

4.6.08). This results in a diluted EPS that is greater than basic EPS for discontinued operations (and net loss, if applicable).[260-10-45-18]

For example, using the information in Example 4.6.10, which assumes 200,000 shares to be included in the basic EPS denominator, and 220,000 shares to be included in the diluted EPS denominator, EPS information for Year 2 would be as follows.

	Income (loss)	Basic EPS	Diluted EPS
Income from continuing operations	$ 1,000,000	$ 5.00	$ 4.55
Loss from discontinued operations	(3,000,000)	(15.00)	(13.64)
Net loss	**$(2,000,000)**	**$ (10.00)**	**$ (9.09)**

Example 14 in Topic 260 (reproduced below) illustrates the control number guidance to determine antidilutive securities.

Excerpt from ASC 260-10

• > Example 14: Antidilutive Securities

55-90 This Example illustrates the guidance in paragraph 260-10-45-18.

55-91 Assume that Entity A has income from continuing operations of $2,400, a loss from discontinued operations of $(3,600), a net loss of $(1,200), and 1,000 common shares and 200 potential common shares outstanding. Entity A's basic per-share amounts would be $2.40 for continuing operations, $(3.60) for the discontinued operation, and $(1.20) for the net loss. Entity A would include the 200 potential common shares in the denominator of its diluted per-share computation for continuing operations because the resulting $2.00 per share is dilutive. (For illustrative purposes, assume no numerator impact of those 200 potential common shares.) Because income from continuing operations is the control number, Entity A also must include those 200 potential common shares in the denominator for the other per-share amounts, even though the resulting per-share amounts [$(3.00) per share for the loss from discontinued operation and $(1.00) per share for the net loss] are antidilutive to their comparable basic per-share amounts; that is, the loss per-share amounts are less.

4.7 Step 5: Identify dilutive potential common shares and determine diluted EPS

Excerpt from ASC 260-10

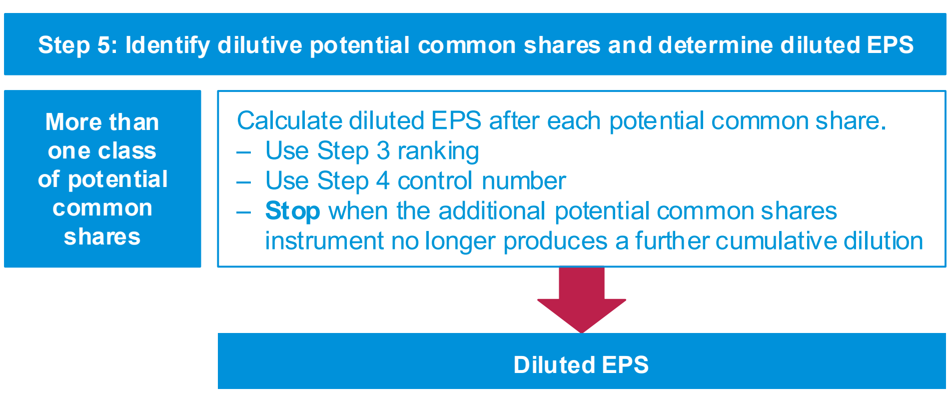
• > No Antidilution

45-17 The computation of diluted EPS shall not assume conversion, exercise, or **contingent issuance** of securities that would have an antidilutive effect on EPS. Shares issued on actual conversion, exercise, or satisfaction of certain conditions for which the underlying potential common shares were antidilutive shall be included in the computation as outstanding common shares from the date of conversion, exercise, or satisfaction of those conditions, respectively. 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.

45-18 Convertible securities may be dilutive on their own but antidilutive when included with other potential common shares in computing diluted EPS. To reflect maximum potential dilution, each issue or series of issues of potential common shares shall be considered in sequence from the most dilutive to the least dilutive. That is, dilutive potential common shares with the lowest earnings per incremental share shall be included in diluted EPS before those with a higher earnings per incremental share. Example 4 (see paragraph 260-10-55-57) illustrates that provision. Options and warrants generally will be included first because use of the treasury stock method does not affect the numerator of the computation…

4.7.10 Overview

The last step (Step 5) is to identify the dilutive potential common shares and calculate diluted EPS.



4.7.20 Multiple classes of potential common shares – dilutive or antidilutive?

If an entity has more than one class of potential common shares outstanding during the reporting period, its basic EPS from continuing operations is adjusted for the effect of each class of potential common shares one by one, from the most dilutive to the least dilutive, in sequence and cumulatively. [260-10-45-17 – 45-18]

In each of these 'sub-steps', the 'before' and 'after' EPS amounts are compared. If the adjusted EPS from continuing operations at that sub-step is less than the previous amount (assuming there is income), the class of potential common shares in question is dilutive.

This process is repeated for each class in sequence according to the ranking identified in section 4.5. The process is stopped when a particular class of potential common shares no longer produces a further dilution; the most dilutive EPS amount is from the 'before' amount at this sub-step.

Because the objective of diluted EPS is to determine the maximum dilutive effect of an entity's potential common shares on a cumulative basis, it is possible that a class of potential common shares may be regarded as dilutive on its own but nevertheless be excluded from the diluted EPS calculation because it is antidilutive on a cumulative basis. [260-10-45-18]

Example 4.7.10
Diluted EPS – identifying antidilutive potential common shares

This example continues from Example 4.5.10.

The ordering of the potential common shares (from most to least dilutive) determined in that example is:

— options
— convertible preferred shares
— convertible debt.

Potential common shares are included in calculating diluted EPS from the most to the least dilutive – lowest EPIS in the above list to highest EPIS.

The following additional information is relevant.

— Income available to common shareholders is $10,000,000.
— Weighted-average number of common shares outstanding is 2,000,000.

Dilutive or antidilutive?

Diluted EPS

5 Identify dilutive potential common shares and determine diluted EPS

	Income available to common shareholders	Weighted-avg. no. of shares	EPS	Dilutive?
As reported	$10,000,000	2,000,000	$5.00	
Options [presumed increase of 1,000 in no. of shares]	$10,000,000	2,001,000	$4.99	✓
Convertible preferred shares [presumed increases of $4,000,000 in income and 2,000,000 in no. of shares]	$14,000,000	4,001,000	$3.50	✓
Convertible debt [presumed increases of $118,500 in income and 10,000 in no. of shares]	$14,118,500	4,011,000	$3.52	✗

Because diluted EPS increases from $3.50 to $3.52 when the convertible debt is included, the convertible debt is considered antidilutive and is ignored in the calculation of diluted EPS.

Therefore, diluted EPS is $3.50.

4.7.30 Determining diluted EPS

Diluted EPS for continuing operations is calculated in the process described in section 4.7.10. Income (loss) from discontinued operations is added or reduced to calculate the diluted EPS from net income. The weighted-average number of shares is the same as used for EPS from continuing operations.

4.8 Applying the five-step approach

Example 4.8.10
Diluted EPS – simple example

This example builds on Example 3.5.10 and illustrates the determination of diluted EPS when an entity has more than one class of potential common shares.

The following is the movement in ABC's shares and potential common shares during Year 1.

Year 1	Transaction	Common shares	Treasury shares	Preferred shares	Contingently issuable shares
Jan. 1	Balance	3,000,000	(500,000)	500,000	300,000
Jan. 15	Stock dividend – 5% (no corresponding change in resources)	150,000	(25,000)	–	15,000
Feb. 1	Share repurchase	–	(200,000)	–	–
Aug. 1	Shares issued for cash	400,000	–	–	–
Dec. 31	**Balance**	**3,550,000**	**(725,000)**	**500,000**	**315,000**

The following additional information about the preferred shares and contingently issuable common shares is relevant for Year 1.

- Preferred shares: On January 1, each preferred share is convertible into two common shares. Following the stock dividend on January 15, this conversion factor changes to 2.1.
- Contingently issuable common shares: The common shares are issuable for no further consideration to the former shareholders of Subsidiary at the end of Year 2 if the market price of ABC's common shares is above $15 at that time. ABC concludes that these shares are classified as equity. On December 31, the market price of ABC's common shares is above $15. The stock dividend changes the number of shares contingently issuable from 300,000 to 315,000.
- On November 15, noncumulative preferred dividends of $1.20 per share were declared. The dividends were paid on December 15. Preferred shares do not participate in additional dividends with common shares.
- In Year 1, ABC has net income of $4,600,000, which comprises income of $5,000,000 from continuing operations and a loss of $400,000 from discontinued operations.

The basic EPS calculations for income from continuing operations for Year 1 are the same as presented in Example 3.5.10; note that Example 3.5.10 does not include a discontinued operation.

Diluted EPS calculations – Year 1

Diluted EPS

1 Identify potential common shares

ABC has two classes of outstanding potential common shares:

i. the preferred shares, which are convertible in the future into common shares; and

ii. the contingently issuable shares, which may be issued as common shares at the end of Year 2.

The contingently issuable shares under (ii) are considered in the diluted EPS calculation because the conditions related to share price would be met if the reporting date were the end of the contingency period (see section 4.3). For further discussion of contingently issuable common shares, see section 6.10.

2 For each class of potential common shares, calculate EPIS

i. Preferred shares

Potential adjustments to numerator: The numerator for the EPIS calculation is the effect of dividends attributable to preferred shareholders, using the calculation of basic EPS in Example 3.5.10: $600,000.

Potential adjustments to denominator: The shares reflect the adjusted conversion factor from the stock dividend – i.e. 2.1. Therefore, the adjustment to the denominator is 1,050,000 [500,000 × 2.1].

EPIS = $600,000 ÷ 1,050,000 = $0.57

ii. Contingently issuable shares

Potential adjustments to numerator: The shares are classified as equity, and therefore there is no effect on income for the year and no adjustment to the numerator.

Potential adjustments to denominator: The number of common shares issuable is 315,000.

EPIS = $0 ÷ 315,000 = $0.00

3 Rank the potential common shares

As noted in section 4.5, the ranking from the most dilutive to the least dilutive is:

1. Contingently issuable shares: EPIS = $ 0.00
2. Preferred shares: EPIS = $0.57

Note that the contingently issuable shares are the most dilutive (while having a $0 EPIS) as they are potential common shares that have a denominator adjustment but do not have a numerator adjustment. See section 4.5.

4 Determine basic EPS from continuing operations

The control number and basic EPS are:

Numerator for basic EPS from continuing operations [$5,000,000 income from continuing operations – $600,000 preferred dividends] (control number)	$4,400,000
Denominator for basic EPS (see Example 3.5.10)	2,608,333

Basic EPS from continuing operations = $4,400,000 ÷ 2,608,333 = $1.69.

5 **Identify dilutive potential common shares and determine diluted EPS**

	Earnings	Weighted-average number of shares	Per share	Dilutive?
Basic EPS from continuing operations	$4,400,000	2,608,333	$1.69	
Contingently issuable shares	–	315,000		
Subtotal	$4,400,000	2,923,333	$1.51	✓
Preferred shares	600,000	1,050,000		
Diluted EPS from continuing operations	**$5,000,000**	**3,973,333**	**$1.26**	✓

Therefore, the diluted EPS from continuing operations is $1.26 [$5,000,000 ÷ 3,973,333].

Diluted EPS from total operations is further calculated as follows.

	Earnings	Weighted-average number of shares	EPS
Diluted EPS from continuing operations	$5,000,000	3,973,333	$1.26
Diluted EPS from discontinued operations	(400,000)	–	(0.10)
Diluted EPS from total operations	**$4,600,000**	**3,973,333**	**$1.16**

Example 4 of Topic 260 (reproduced below) also illustrates antidilution sequencing.

Excerpt from ASC 260-10

• > Example 4: Antidilution Sequencing

55-57 This Example illustrates the **antidilution** sequencing provisions described in paragraph 260-10-45-18 for Entity A for the year ended December 31, 20X0. This Example has the following assumptions:

a. Entity A had income available to common stockholders of $10,000,000 for the year 20X0.
b. 2,000,000 shares of common stock were outstanding for the entire year 20X0.
c. The average market price of the common stock was $75.
d. Entity A had the following potential common shares outstanding during the year:

1. Options (not compensation- related) to buy 100,000 shares of common stock at $60 per share.
2. 800,000 shares of convertible preferred stock entitled to a cumulative dividend of $8 per share. Each preferred share is convertible into two shares of common stock.
3. 5 percent convertible debentures with a principal amount of $100,000,000 (issued at par). Each $1,000 debenture is convertible into 20 shares of common stock.

e. The tax rate was 40 percent for 20X0.

55-58 The following table illustrates calculation of earnings per incremental share.

Determination of Earnings per Incremental Share

	Increase in income	Increase in Number of Common Shares	Earnings per Incremental Share
Options	-	20,000[(a)]	-
Convertible preferred stock	$ 6,400,000[(b)]	1,600,000[(c)]	$ 4.00
5% convertible debentures	$ 3,000,000[(d)]	2,000,000[(e)]	$ 1.50

(a) [($75 – $60) ÷$75] × 100,000

(b) 800,000 shares × $8

(c) 800,000 shares × 2

(d) ($100,000,000 × 5%) less taxes at 40%

(e) 100,000 debentures × 20

55-59 The following table illustrates calculation of diluted EPS.

Computation of Diluted Earnings per Share

	Income Available	Common Shares	Per Share	
As reported	$ 10,000,000	2,000,000	$ 5.00	
Options	-	20,000		
	10,000,000	2,020,000	4.95	Dilutive
5% convertible debentures	3,000,000	2,000,000		
	13,000,000	4,020,000	3.23	Dilutive
Convertible preferred stock	6,400,000	1,600,000		
	$ 19,400,000	5,620,000	3.45	Antidilutive

Note that because diluted EPS increases from $3.23 to $3.45 when convertible preferred shares are included in the computation, those convertible preferred shares are antidilutive and are ignored in the computation of diluted EPS. Therefore, diluted EPS is reported as $3.23.

5. Participating securities and the two-class method

Detailed contents

New item added in this edition: **

Examples

5.4 Presentation of EPS under the two-class method

Question

5.5 Allocating losses under the two-class method

Questions

Examples

5.7.05	Basic and diluted EPS calculations for an entity with two classes of common shares **
5.7.10	Basic and diluted EPS calculations for an entity with participating RSUs
5.7.20	Effect of an in-the-money equity-classified participating warrant on dilutive EPS

5.8 Examples of diluted EPS using the two-class method

5.1 How the standard works

When an entity has a multilayered capital structure, it may have to present EPS information for more than one class of shares. In this instance, it uses the two-class method to allocate undistributed earnings to each such class of shares, with the goal of determining how much of the earnings are available for each class.

An entity has a multilayered capital structure when it has:

— two or more classes of common shares that have different dividend rates without prior or senior rights; and/or

— participating securities in addition to common shares. A participating security is one that contains a non-forfeitable right to participate in distributions of earnings. It can be in the form of preferred shares, debt or a derivative financial instrument.

Presentation of EPS information for participating securities is not required, although an entity may choose to do so (see Question 9.2.108). However, undistributed earnings may have to be allocated to those securities under the two-class method to determine the undistributed earnings attributable to the common shares. Therefore, to apply the two-class method, an entity needs to identify any participating securities (see section 5.2).

The following are the steps in the two-class method.

Step A	Adjust income (loss) by the amount of dividends declared in the period for each class of stock, and by the contractual amount of dividends or interest not recognized in earnings for the period that has yet to be paid – e.g. unpaid cumulative dividends
Step B	Notionally allocate the remaining earnings to the different classes of common stock and participating securities as if all of the earnings for the period had been distributed (participation feature)
Step C	Determine earnings attributable to each class of instruments (numerator) by adding together the amount allocated for dividends (see Step A) and the amount notionally allocated for the participation feature (see Step B)
Step D	Divide earnings attributable to each class of common stock by weighted-average number of shares outstanding for the period

5.2 Identifying participating securities

Excerpt from ASC 260-10

• > Participating Securities and the Two-Class Method

45-59A The capital structures of some entities include:

a. Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share)
b. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

45-60 The two-class method is an earnings allocation formula that treats a **participating security** as having rights to earnings that otherwise would have been available to common shareholders but does not require the presentation of basic and diluted EPS for securities other than common stock. The presentation of basic and diluted EPS for a participating security other than common stock is not precluded.

45-60A All securities that meet the definition of a participating security, irrespective of whether the securities are convertible, nonconvertible, or potential common stock securities, shall be included in the computation of basic EPS using the two-class method.

45-61 Fully vested stock-based compensation subject to the provisions of Topic 718, including fully vested options and fully vested stock, that contain a right to receive dividends declared on the common stock of the issuer, are subject to the guidance in paragraph 260-10-45-60A.

45-61A Unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method under the requirements of paragraph 260-10-45-60A.

45-62 Dividends or dividend equivalents transferred to the holder of a **convertible security** in the form of a reduction to the conversion price or an increase in the conversion ratio of the security do not represent participation rights. This guidance applies similarly to other contracts (securities) to issue an entity's common stock if these contracts (securities) provide for an adjustment to the exercise price that is tied to the declaration of dividends by the issuer. The scope of the guidance in this paragraph excludes forward contracts to issue an entity's own equity shares.

45-63 In a forward contract to issue an entity's own equity shares, a provision that reduces the contract price per share when dividends are declared on the issuing entity's common stock represents a participation right. Such a provision constitutes a participation right because it results in a noncontingent transfer of value to the holder of the forward contract for dividends declared during the forward contract period. That is, the forward contract holder has a right to participate in the undistributed earnings of the issuing entity because a dividend declaration by the issuing entity results in a transfer of value to the holder of the forward contract through a reduction in the forward purchase price per share. Because that value transfer is not contingent-as opposed to a similar reduction in the exercise price of an option or **warrant**-the forward contract is a participating security, regardless of whether, during the period the contract is outstanding, a dividend is declared.

The two-class method is used to determine income available to common shareholders when an entity has a multilayered capital structure, such as:

— equity instruments that participate in dividends with common shares according to a predetermined formula, sometimes with an upper limit on the extent of participation (participating equity instruments); and/or

— a class of common shares with a dividend rate different from that of another class of common shares but without prior or senior rights.

These instruments may reduce the entitlement of a common shareholder to the income (or, when applicable, increase the allocation of the loss) of an entity. Therefore, the numerator for basic EPS is adjusted for the effects of these instruments.

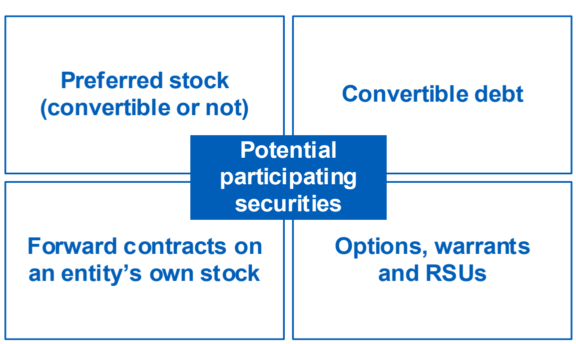
Excerpt from ASC 260-10

20 Glossary

Participating Security

A security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.

Under this definition, securities or other contracts (e.g. share-based payments, forward contracts, preferred shares, convertible debt, convertible preferred shares) are participating securities if they are entitled to participate in distributions of earnings with common shareholders. The form of the instrument does not matter, but the rights to participation (e.g. rights to dividends) cannot be forfeitable. The determination is made based on the current form of the instrument, without considering exercise or conversion.



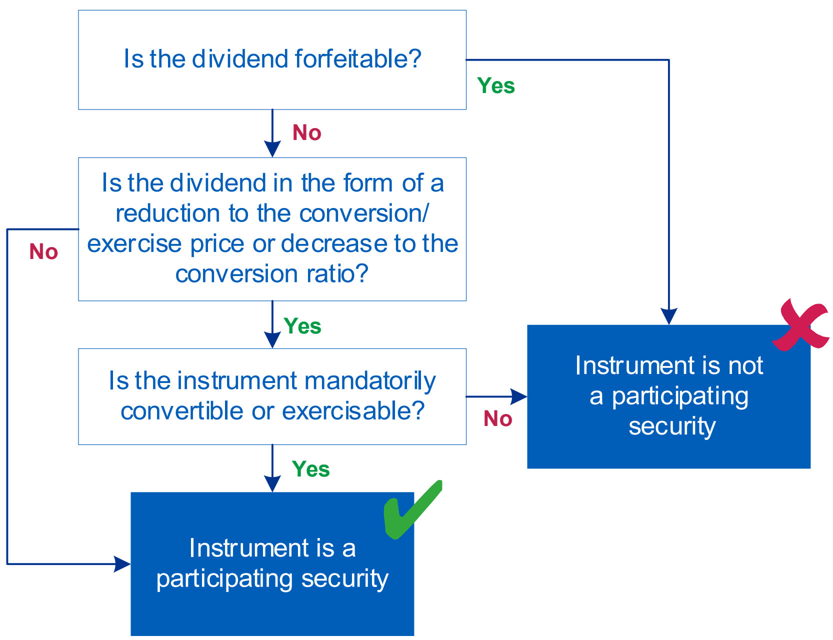
Contingent participation rights

A contingent participation right is the right to participate in dividends only when a specified future event occurs, such as upon a business combination or achievement of a target share price. A contingent participation right is usually considered a participation right, although undistributed earnings are only allocated to the participating security once the contingency is resolved.

However, a right that reduces the exercise price of an option or warrant or the conversion price of a nonmandatorily convertible instrument (such as convertible debt) when an entity declares a dividend is not a participation right. Such a reduction in exercise or conversion price is deemed a dividend, but it is only received if the instrument is exercised or converted (see Question 5.2.50). [260-10-45-62 – 45-63]

Identifying participating securities

The following flowchart is helpful in understanding when a dividend right gives rise to a participating security.



Observation

Identifying a participating security vs allocating undistributed earnings to a participating security

Under the two-class method, not every participating security's terms will result in an allocation of *undistributed* earnings. Determining if an instrument is a participating security is separate and distinct from determining if undistributed earnings should be allocated to the instrument.

For undistributed earnings to be allocated to the participating security, the participation rights must be objectively determinable and nondiscretionary. This means that the right must be based on a predetermined formula (e.g. on a one-to-one basis with common shares) and not based on management's discretion.

However, an entity may identify an instrument as a participating security and allocate distributed earnings to it, but not allocate undistributed earnings to it. For further discussion of when to allocate undistributed earnings to a participating security, see the flowchart in section 5.3.20, and section 5.6.

Question 5.2.20

If an entity has not paid dividends, can it still have participating securities?

Interpretive response: Yes. When determining whether an instrument is a participating security, it is irrelevant whether the entity has paid or ever will pay a dividend to common shareholders. This is because the definition of a participating security is not based on common dividends per se, but on the right to participate in distributions of earnings with common shares. [260-10-45-66]

For example, if the board of directors passes a resolution not to pay dividends for a period of time, a preferred share with a participation feature is still considered a participating security for EPS purposes. This is because the resolution does not eliminate the instrument's contractual right to participate in distributions.

Question 5.2.30

If an instrument's participation rights are governed by a formula or cap, can the instrument be a participating security?

Interpretive response: Yes. When participation is governed by a formula or contains a cap, that formula or cap is considered in determining the amount of undistributed earnings to allocate to the participating security. Section 5.6 explains how to analyze these types of provisions. [260-10-55-28, 55-30]

Question 5.2.40

Can a contingent participation right result in a participating security?

Interpretive response: Yes. However, under the two-class method an allocation of undistributed earnings to a participating security with contingent participation rights will only be made to those securities when the contingent event is satisfied as of the reporting date (e.g. attaining a certain share price), regardless of whether distributions actually occurred (see Question 5.2.20). [260-10-55-27]

Question 5.2.45

Are equity instruments with forfeitable dividends participating securities?

Interpretive response: No. Instruments with rights only to forfeitable dividends are not participating securities, and therefore do not need to be included in EPS using the two-class method (i.e. undistributed earnings are not allocated to them). [260-10-45-60A, 45-59A]

See Questions 3.3.117 and 5.2.160 for further guidance on forfeitable dividends and unvested share-based payment awards, respectively.

Question 5.2.50

Is a reduction in the conversion or exercise price of an instrument (or an increase in the conversion ratio) a participation right?

Interpretive response: It depends on whether the instrument is mandatorily convertible or exercisable. [260-10-45-62]

— **Mandatorily convertible or exercisable.** A reduction in conversion price is considered a participation right and the instrument is a participating security. This is because the value of the dividends will always be received. when the instrument is converted or exercised (there is no contingency, therefore the benefit will always be received). See Question 5.2.60 for when the conversion price adjustment is triggered only within a set share price range.

— **Not mandatorily convertible or exercisable.** When the holder of a contingently convertible instrument (i.e. convertible debt) or exercisable contract (i.e. stock option) receives dividends or dividend equivalents in the form of a reduction to the conversion or exercise price (or an increase in the conversion ratio) of the instrument, the dividends or dividend equivalents are not participation rights. This is because the value of the dividends is only received if the instrument is converted or exercised, and there is a possibility that it will not be converted/exercised and the benefit will not be received. However, if the conversion price or exercise price is nominal such that the conversion or exercise is virtually assured, the expected benefit may result in a participating security.

If a forward contract to issue an entity's own equity shares includes a provision that reduces the contract price when dividends are declared, the potential reduction in contract price represents a participation right and the forward contract is considered a participating security. This is because there is no contingency in the settlement of the forward contract (i.e. it will always be settled). This is the case even if dividends are not declared (consistent with Question 5.2.20). [260-10-45-63]

Question 5.2.55

Is an increase in liquidation preference when dividends are declared on common shares a participation right?

Interpretive response: Yes, although it is a contingent participation right. The preferred shares are participating securities, because the definition of a participating security is one "that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not". However, the distribution of earnings is contingent upon liquidation.

Because the benefit is realized only upon liquidation (i.e. it is a contingent participation event that will only occur when the entity ceases operations), it is not necessary to calculate EPS using the two-class method. See Question 5.2.40. [260-10 Glossary]

Question 5.2.60

Are mandatorily convertible preferred shares always participating securities?

Interpretive response: No. As discussed in Question 5.2.50, a mandatorily convertible instrument with a feature that allows the holder to participate in distributions to common shareholders by adjusting the conversion price is considered a participating security because the holder of the instrument receives an unconditional benefit when dividends are paid.

However, additional analysis is required when a conversion price adjustment feature is contingent – e.g. on the common shares price being above or below a specific price per share at the conversion date. In that case, the right to participate in dividends is conditional on the share price at settlement. Generally, we believe if there is more than a remote possibility that the share price at settlement will be within the range wherein the holder would receive a benefit for distributions, the instrument should be considered a participating security. In contrast, if it is reasonably possible that the share price at settlement will be within the range wherein the holder would not receive a benefit for distributions made during the contract period, the instrument might contain sufficient optionality to preclude it from being a participating security.

To determine the probability of the share price trading within a specified range per share at settlement (e.g. $50 – $75), a modeling technique may be used that considers the term of the instrument, the expected return of the underlying common shares and the expected volatility of the common share price during the term of the instrument. The probability assessment is performed each reporting period.

Question 5.2.70

Is a forward contract to purchase an entity's own shares a participating security if its strike price floor is adjusted for declared dividends?

Background: An entity enters into a forward contract to purchase $100 million of its own shares in three months. The number of shares to be delivered by the counterparty is $100 million divided by the greater of:

— the volume-weighted average price per share (VWAP) during the three-month contractual term (the strike price); or
— $1.00, subject to adjustment if the entity declares dividends (the floor price).

In this scenario, the benefit of the dividend is only received if the VWAP is lower than the floor price.

Interpretive response: It depends. In certain cases, we believe an adjustment to the floor price does not require the forward contract to be considered a participating security. Careful consideration of the provisions and their effect on the settlement of the contract is required.

A provision that affects the contract price per share when dividends are declared on the issuing entity's common shares represents a participation right because it results in a noncontingent transfer of value to the holder of the forward contract during the term of the contract. In contrast, the adjustment to the strike price in an option contract is contingent and therefore is not a participation right. [260-10-45-62 – 45-63]

In this example, an entity should carefully consider whether the adjustment to the floor price would cause the contract to settle at the floor price and not the VWAP.

— If it is more than remote that the forward contract will settle at the floor price, the forward contract is a participating security.

— However, if it is remote that the floor price will not be in-the-money at the time of the adjustment, it is also remote that the forward price would be adjusted (because the VWAP price is used). In that case, the forward contract is not a participating security, however the forward is evaluated each reporting period that the forward remains outstanding.

Question 5.2.80

Is a forward contract to purchase an entity's own shares a participating security if the counterparty can adjust the strike price depending on when dividends are paid?

Background: An entity enters into a forward contract to purchase $100 million of its own shares in three months. The number of shares to be delivered by the counterparty is $100 million divided by the greater of:

- the volume-weighted average price per share (VWAP) during the three-month contractual term (the strike price); or
- $1.00, subject to adjustment if the entity declares dividends (the floor price).

The strike price can be adjusted by the counterparty for differences in timing between when the entity intended to pay dividends under the contract and when the dividends were actually paid.

Interpretive response: Yes. We believe a forward contract to purchase an entity's own shares is a participating security even though the strike price can be adjusted by the counterparty for differences in timing between when the entity intended to pay dividends under the contract and when the dividends were actually paid.

Excerpt from ASC 260-10

• > Participating Securities and Undistributed Earnings

55-26 If a participating security provides the holder with the ability to participate with the holders of common stock in dividends declared contingent upon the occurrence of a specified event, the occurrence of which is subject to management discretion or is not objectively determinable (for example, liquidation of the entity or management determination of an extraordinary dividend), then the terms of the participating security do not specify objectively determinable, nondiscretionary participation rights; therefore, undistributed earnings would not be allocated to the participating security.

We do not believe the dividend adjustment feature described above is objectively determinable until:

- a dividend payment occurs that is different from that specified under the forward contract; and
- the counterparty determines the difference between the long and short position expected and the actual holdings on the date of the payment.

Therefore, although the forward contract is considered a participating security, there would be no allocation of undistributed earnings to the forward contract when calculating EPS until an adjustment is required under the contract.

Question 5.2.90

Is a forward contract to issue an entity's own shares a participating security if the strike price can be adjusted for the payment of stock dividends but not cash dividends?

Background: An entity enters into a forward contract to issue $100 million of its shares in three months. The forward contract includes a provision whereby the strike price is adjusted if there is a change in the capital stock of the entity during the term of the forward contract due to reclassification, recapitalization, stock split or stock dividend.

Interpretive response: We believe it is unusual for a forward sales contract to specifically adjust only for dividends in shares. When this scenario does occur, we believe there are two acceptable views on whether the contract is a participating security.

— **View A.** Any dividend adjustment always results in a participating security, because the accounting literature does not specifically state whether the dividend must be in cash.

— **View B.** The forward contract does not represent a participating security if the facts and circumstances result in the dividend adjustment provision being a conditional transfer of value. With the condition that there must first be a change in the capital stock structure, the forward contract results in a conditional transfer of value, and the instrument is not a participating security.

These views apply only when the strike price adjustment provision contractually applies only to dividends in shares. In contrast, if the entity has discretion regarding the type of dividend adjustment, the dividend adjustment provision does not result in the allocation of undistributed earnings to the forward sales contract.

Therefore, the entity should consider whether it has constraints that prohibit it from declaring all of the earnings for the period as a dividend in cash or a dividend in shares. If it is always within the entity's control to declare a dividend entirely in cash, a dividend entirely in shares, or a dividend in a combination of cash and shares, the dividend adjustment provision likely is discretionary; this is because the entity has complete control of what type of dividend it would declare – cash, shares or a combination thereof.

Question 5.2.100

Can a forward purchase contract be a participating security other than when its strike price is adjusted?

Interpretive response: Yes. If the shares underlying the forward purchase contract are entitled to dividends, the forward purchase contract is a participating security, and EPS is calculated using the two-class method. [260-10-45-60A]

However, in general, the shares underlying written forward purchase contracts are excluded from basic EPS and included in diluted EPS according to the reverse treasury stock method, if their effect is dilutive (see section 6.15). [260-10-45-35]

In addition, if a forward purchase contract to purchase an entity's own shares requires physical settlement, by tendering cash in exchange for a fixed number of shares, the shares are excluded from the denominator of both basic and diluted EPS calculations. [480-10-45-4]

Question 5.2.110

Are noncumulative preferred shares participating securities if dividends may only be declared on common shares in a period when noncumulative dividends are also declared?

Background: ABC Corp. issues $100 million of Series A Preferred Shares with the following features:

— liquidation preference of $100 million, senior to common shares; and
— noncumulative dividends of 8% per annum (only if and when declared).

The following additional facts are relevant.

— ABC may not declare dividends on common shares in any period unless noncumulative dividends are also declared.

— The preferred shareholders participate with and receive their dividends before common shareholders.

— ABC declared no dividends on preferred or common shares during the reporting period and it has no other outstanding securities that could potentially affect the numerator of its EPS calculations.

Interpretive response: In our experience, there are two views in practice.

— **View A: The Series A Preferred Shares are participating securities.** In any period in which an entity distributes earnings to common shareholders, the holders of Series A Preferred Shares are unconditionally entitled to their 8% per annum dividend. In determining EPS, the principle is to determine what would happen if all current earnings for the period were distributed. To the extent there are undistributed earnings for a period, the Series A Preferred Shares are entitled to their preferred dividends before any of those earnings are used to pay dividends on common shares. Therefore, View A supporters believe that an entity should apply the two-class method.

— **View B: The Series A Preferred Shares are *not* participating securities.** This view arises because the Series A Preferred Shares do not participate in undistributed earnings with the common shares; instead, they have a preference in dividends. View B supporters believe that a participation feature subject to the two-class method provides only for dividends in circumstances in which the common shares also receive a dividend. Accordingly, View B supporters believe that noncumulative, fixed-rate preferred shares have a preference in dividends, but that preference does not constitute a participation feature.

View B supporters believe that the principle governing View A is the two-class earnings allocation method. The method may only be applied to entities with capital structures that include either: [260-10-45-59A]

— multiple classes of common shares with different dividend rates; or

— securities that may participate in dividends with common shares according to a predetermined formula (e.g. two for one) with, at times, an upper limit on the extent of participation (e.g. up to, but not beyond a specified amount per share).

Those supporters believe that preferred shares with a fixed, noncumulative dividend do not meet the definition of a participating security simply because it has preference in dividends. A dividend preference is a feature in virtually all preferred shares, whether cumulative or noncumulative.

View B supporters observe that the treatment of fixed dividends on preferred shares is addressed in calculating income available to common shareholders in paragraph 260-10-45-11. Based on that guidance, an entity only deducts noncumulative dividends from income available to common shareholders to the extent they are declared. This is consistent with AICPA Technical Practice Aid 4210.04, *Accrual of Preferred Dividends.* While nonauthoritative, the TPA clearly distinguishes the treatment of noncumulative dividends versus cumulative dividends. The last paragraph of the TPA states:

> If preferred dividends are not cumulative, only the dividends declared should be deducted. In all cases, the effect that has been given to preferred dividends in arriving at income available to common shareholders in computing basic EPS should be disclosed for every period for which an income statement is presented.

View B supporters also observe that examples of a participating security in Section 260-10-55 has an allocation formula where the participating security receives a proportion of all dividends (sometimes with a limit) that is expressed as a ratio, not just a preference over common dividends.

We believe that applying the two-class method (View A) to noncumulative, fixed-rate preferred shares is an acceptable approach because it is consistent with the principle that an entity calculates EPS as if all earnings for the period were distributed. However, the language from paragraph 260-10-45-11 seemingly contradicts that principle by indicating that noncumulative dividends should not be deducted from the numerator of EPS calculations unless declared (View B). Given the apparent conflict, we believe applying either View A or View B to noncumulative, fixed-rate preferred shares is acceptable.

However, if a preferred share contains an explicit participation feature based on a predetermined formula, it is subject to the two-class method regardless of the entity's policy for the fixed portion of the noncumulative dividend.

Background example

The two views apply as follows to the background example.

— If ABC applies View A, its EPS numerator is first reduced by the 8% fixed noncumulative dividend on the preferred shares, even though not declared.
— In contrast, if ABC applies View B, no dividends would be allocated to the preferred shares.

Question 5.2.115

Are cumulative preferred shares participating securities?

Interpretive response: It depends. Cumulative dividends are adjusted from the EPS numerator whether or not declared, and this does not affect whether the shares are participating securities. When cumulative preferred share dividends are required to be paid before dividends can be paid on common shares, we believe there are two views as to whether preferred shares are participating securities (see Question 5.2.110).

However, when cumulative preferred shares are entitled to participate in dividends *with* the common shares, the preferred shares are participating securities. [260-10 Glossary]

Question 5.2.120

Can an instrument with a contractual antidilution provision in the event of an equity restructuring be a participating security?

Interpretive response: No. We believe that a contractual antidilution provision, in the event of an equity restructuring (as defined in Topic 718) that provides for an adjustment to the conversion or exercise terms of an instrument, or a cash payment, does not represent a participation right and the instrument is not considered a participating security.

Question 5.2.130

Is the two-class method applied to tracking stock?

Interpretive response: Yes. Tracking stock is a class of shares referenced to a specific business activity or entity. A registrant may issue multiple tracking stocks with each one tied to a different business activity. An entity with multiple tracking stocks should use the two-class method to calculate earnings attributable to each class. [2000 AICPA Conf]

Question 5.2.135

How is the two-class method applied to tracking stock?

Interpretive response: Yes. When an entity pays a premium to exchange a class of tracking stock for shares in a different class (i.e. of tracking or regular common stock), this premium is treated as a deemed dividend for the tracking stock shareholders and deducted from income available to common shareholders for the class of shares being issued.

Question 5.2.140

Is the two-class method applied to trailing fees stock?

Background: Certain publicly registered, unlisted direct participation programs, including unlisted Real Estate Investment Trusts (nontraded REITs), have multiple classes of shares/units with different commission and fee arrangements. These may include a sales commission and distribution fee structure that pays the dealer-manager over a period of time, but not to exceed the time period that the shares/units remain outstanding. These ongoing periodic fees to a dealer-manager are commonly referred to as trailing fees, and the class of security as T-shares.

Many of the direct participation programs have a consistent dividend rate across their multiple classes of shares/units, regardless of whether the share/unit holder paid all commissions and distribution fees upon purchase or over time during share/unit ownership. For those share classes for which commissions and distributions are paid over time, the trailing fees are deducted from the dividend payment and paid directly to the broker-dealer. As a result, the share/unit holder receives a dividend payment that is net of trailing fees paid to the broker-dealer.

Interpretive response: We believe applying the two-class method is optional for share classes that differ only based on the payment of sales commissions and distribution fees. In our experience, there are two views in practice:

— **View A: Apply two-class method.** Applying the two-class method is consistent with a view that the differing amounts received by the share/unit holders for different share/unit classes (distribution less trailing fees) are differing dividend rates. Additionally, as each class of share/units participates in the undistributed earnings of the entities, they should be considered to be participating securities and the two-class method should be applied to calculate EPS.

— **View B: Do *not* apply two-class method.** The dividend rate for each share/unit class is the same, and therefore income should be allocated to each class using a consistent rate for EPS purposes – i.e. each share/unit class should not be considered a separate participating security. The difference in the net cash received by the investor based on the class of shares/units is not based on the entity's earnings, but rather is based on the payment for equity raising activities. Because equity raising activities do not affect earnings of the entity, the trailing fee payments should not be viewed as causing different dividend rates and therefore should not affect the allocation of income for EPS.

Regardless of whether an entity applies the two-class method in calculating EPS, it should disclose the existence of multiple share classes, including the effect of any trailing fees on cash received from distributions by the investors. [505-10-50-3]

An entity also should consider other potential differences in the share classes that might require applying the two-class method. For example, if management fees are calculated differently for different share classes (including performance fees based on net asset values when the net asset values are different for each class of shares) an entity may be required to apply the two-class method and present EPS for each class of common shares/units. [260-10-45-59A]

Question 5.2.150

Is the two-class method applied to shares subject to an own-share lending arrangement?

Interpretive response: It depends. If, based on the terms of the own-share lending arrangement, dividends on the loaned shares are *not* reimbursable to the entity (i.e. dividends are non-forfeitable), the two-class method is applied. If dividends on the loaned shares are reimbursable to the entity (i.e. dividends are forfeitable), these shares are excluded from EPS calculations, unless default of the share lending arrangement occurs (see Question 3.4.20). [470-20-45-2A]

Share-based payment awards

Generally, share-based payment awards are not considered participating securities because they generally do not participate in earnings distributions until they are exercised or vest (in the case of restricted stock or RSU grants). However, a share-based payment award may be a participating security if: [260-10-45-61 – 45-61A]

- the award is fully vested and unexercised (for option awards), and contains a right to receive dividends; or
- the award is unvested and contains non-forfeitable rights to dividends or dividend equivalents.

In these cases, the award is considered a participating security and is included in the calculation of EPS pursuant to the two-class method. This is because the holder of a share-based payment award, which includes non-forfeitable rights to dividends or dividend equivalents, receives a noncontingent transfer of value each time an entity declares a dividend or dividend equivalent during the contractual period of the share-based payment award. As a result, a share-based payment award, when it has a right to dividends or dividend equivalents, meets the definition of a participating security during the vesting period (for unvested awards) and subsequent to vesting (for vested and unexercised option awards). [260-10-45-68B, 55-76A – 55-76D]

Question 5.2.160
When is an unvested share-based payment award not a participating security?

Interpretive response: Unvested share-based payment awards are not participating securities when the right to receive dividends or dividend equivalents is contingent on vesting or exercise.

For example, the right to receive the dividend or dividend equivalent is contingent, and therefore the award is not a participating security, if the right is:

— forfeited if the award does not vest; or
— received only in the form of a reduced option exercise price, and therefore is effectively forfeited if the award is not exercised.

However, the presence of the right to non-forfeitable dividends results in a designation as a participating security even if the entity is not currently paying or anticipating paying dividends.

5.3 Applying the two-class method

Excerpt from ASC 260-10

• > Participating Securities and the Two-Class Method

45-60B Under the two-class method:

a. Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends). Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.
b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.
c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the EPS for the security.
d. Basic and diluted EPS data shall be presented for each class of common stock.

For the diluted EPS computation, outstanding common shares shall include all potential common shares assumed issued. Example 6 (see paragraph 260-10-55-62) illustrates the two-class method.

45-65 Undistributed earnings for a period shall be allocated to a participating security based on the contractual participation rights of the security to share in those current earnings as if all of the earnings for the period had been distributed. If the terms of the participating security do not specify objectively determinable, nondiscretionary participation rights, then undistributed earnings would not be allocated based on arbitrary assumptions. For example, if an entity could avoid distribution of earnings to a participating security, even if all of the earnings for the year were distributed, then no allocation of that period's earnings to the participating security would be made. Paragraphs 260-10-55-24 through 55-31 provide additional guidance on participating securities and undistributed earnings.

45-66 Under the two-class method the remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. This allocation is required despite its pro forma nature and that it may not reflect the economic probabilities of actual distributions to the participating security holders.

45-68B Paragraph 718-10-55-45 requires that nonrefundable dividends or dividend equivalents paid on awards for which the requisite service is not (or is not expected to be) rendered be recognized as additional compensation cost and that dividends or dividend equivalents paid on awards for which the requisite service is (or is expected to be) rendered be charged to retained earnings. As a result, an entity shall not include dividends or dividend equivalents that are accounted for as compensation cost in the earnings allocation in computing EPS. To do so would include the dividend as a reduction of earnings available to common shareholders from both compensation cost and distributed earnings. *Undistributed* earnings shall be allocated to all share-based payment awards outstanding during the period, including those for which the requisite service is not expected to be rendered (or is not rendered because of forfeiture during the period, if an entity elects to account for forfeitures when they occur in accordance with paragraph 718-10-35-3). An entity’s estimate of the number of awards for which the requisite service is not expected to be rendered (or no estimate, if the entity has elected to account for forfeitures when they occur in accordance with paragraph 718-10-35-3) for the purpose of determining EPS under this Topic shall be consistent with the estimate used for the purposes of recognizing compensation cost under Topic 718. Paragraph 718-10-35-3 requires that an entity apply a change in the estimate of the number of awards for which the requisite service is not expected to be rendered in the period that the change in estimate occurs. This change in estimate will affect net income in the current period; however, a current-period change in an entity’s expected forfeiture rate would not affect prior-period EPS calculations. See Example 9 for an illustration of this guidance.

45-70 See Example 9 (paragraph 260-10-55-71) for an illustration of this guidance.

• > Participating Securities and Undistributed Earnings

55-25 If a participating security provides the holder with the ability to participate in all dividends declared with the holders of common stock on a one-to-one per-share basis, then the undistributed earnings should be allocated between the common stock and the participating security on a one-to-one per-share basis.

5.3.10 Step A: Adjust income from continuing operations for earnings distributed

The first step in applying the two-class method is to adjust income (or loss) from continuing operations for earnings distributed that have not already been recognized in earnings.

Adjust for (unless already recognized in earnings):

- Dividends declared in the current period, for each class of shares.
- Dividends that were not declared, but must be paid for the current period – i.e. cumulative preferred dividends.

But do not adjust for:

- Prior-year cumulative dividends that were not paid at the time, but declared during the current period.
- Unearned preferred dividends that are cumulative only if earned.
- Dividends on share-based payment awards that are not expected to vest and have been charged to expense (see Question 5.3.10).
- Dividends on liability-classified instruments that were already recognized in earnings.

Question 5.3.10

How are share-based payment awards that are not expected to vest or are forfeited during the period accounted for in Step A of the two-class method?

Interpretive response: Under Topic 718, an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur. When an entity declares dividends that also apply to share-based payment awards, dividends paid on awards that are expected to vest (or have vested) are charged to retained earnings. Dividends on awards that are not expected to vest or are forfeited are charged to expense. [718-10-55-45]

When adjusting income (or loss) under the two-class method, no adjustment is made for dividends that were charged to expense in the above circumstances. To do so would effectively be double counting the reduction from income available to common shareholders (see Example 5.7.10). [260-10-45-61A, 45-68B]

Question 5.3.15

How do dividends on preferred shares affect the allocation of distributed earnings in Step A of the two-class method?

Background: When calculating basic EPS (for nonparticipating securities), cumulative dividends on preferred shares are deducted from income available to common shareholders whether or not declared; this is because there is a contractual obligation to pay those dividends.

However, noncumulative dividends on preferred shares are deducted from income available to common shareholders only if declared during the period – or when there are deemed dividends on noncumulative preferred shares; this is because there is no contractual obligation to pay noncumulative dividends. See section 3.3.30.

Interpretive response: Preferred share dividends will affect the allocation of distributed earnings to participating securities differently, depending on whether the preferred share dividends are cumulative or noncumulative.

Cumulative dividends

Cumulative dividends contractually entitle the preferred shareholder to an annual dividend, and therefore the cumulative dividend is considered distributed even if not actually declared or paid.

The full amount of the cumulative dividend for the period is allocated to the preferred shares, even if the amount of the dividend exceeds available earnings. If there is an excess, this results in an undistributed loss to the common shareholders (see Question 5.5.40).

Noncumulative dividends

Noncumulative dividends result in no contractual obligation to distribute a dividend to the preferred shareholder until actually declared. Once declared, an obligation is created for the noncumulative dividends.

When noncumulative dividends are declared during the period, those dividends are allocated to the preferred shares in Step A of the two-class method, even if the amount of the dividend exceeds available earnings. If there is an excess, this results in an undistributed loss to the common shareholders (see Question 5.5.40). Noncumulative dividends can result in an undistributed loss in this situation, because once declared there is an obligation to distribute those dividends.

In addition, Question 5.3.55 discusses allocating undistributed earnings (Step B of the two-class method) for the stated dividend on noncumulative preferred shares that has not been declared or distributed during the period. [260-10-45-60B]

Example 5.3.10
Adjusting income from continuing operations

ABC Corp. has two classes of shares, X and Y, with the following rights.

- Holders of Class X shares are entitled to a fixed dividend per share and have the right to participate in any additional dividends declared. Additional dividends are discretionary.
- Holders of Class Y shares participate equally with holders of Class X shares with respect to any additional discretionary dividends only.
- Both classes of shares participate equally in residual assets upon liquidation.

The following information is also relevant.

- Net income for the period: $2,500
- Dividends paid to holders of Class X shares: $600
- Dividends paid to holders of Class Y shares: $500
- Number of shares outstanding for the period: 100 (Class X and Class Y).

ABC concludes that the Class Y shares are the only common shares for which EPS disclosure is required (see section 5.2).

Class X shares are not common shares because the fixed entitlement creates a preference over the Class Y shares, and the holders of Class Y shares are subordinate to the holders of Class X shares. Class X shares are nevertheless participating equity instruments whose earnings entitlement has to be adjusted in arriving at the numerator for basic EPS for Class Y shares.

Step A: Adjust income from continuing operations for earnings distributed

Net income		**$2,500**
Less: Dividends paid		
To holders of Class X	(600)	
To holders of Class Y	(500)	
Total		**(1,100)**
Remaining earnings		**$1,400**

Example 5.3.15
Adjusting income from continuing operations – cumulative dividends

ABC Corp. has two classes of shares, X and Y, with the following rights:

- Holders of Class X shares, which have a par value of $1,000, are entitled to a 5% cumulative dividend per share, and have the right to participate with common shares in any additional discretionary dividends declared.

— Holders of Class Y shares participate equally with holders of Class X shares with respect to any additional discretionary dividends only.

— Both classes of shares participate equally in residual assets upon liquidation.

The following information is also relevant.

— Net income for the year: $2,500
— ABC has not paid or declared any dividends during the last two years.
— Number of shares outstanding for the year: 100 (Class X and Class Y).

ABC concludes that the Class Y shares are the only common shares for which EPS disclosure is required (see section 5.2). ABC considers Class X shares to be participating securities.

Class X shares are not common shares because the 5% cumulative dividend creates a preference over the Class Y shares, and the holders of Class Y shares are subordinate to the holders of Class X shares. The Class X shares are considered preferred shares, and the cumulative dividends on Class X shares result in an adjustment to the numerator for basic EPS for Class Y shares.

Step A: Adjust income from continuing operations for earnings distributed

Net income	**$2,500**
Less: Dividends accrued to holders of Class X for current year[1]	(50)
Remaining earnings	**$2,450**

Note:

1. 5% × $1,000 for the current year accrual of Class X cumulative dividends. Dividends accrued in the prior year were deducted from income from continuing operations in the prior year.

Question 5.3.20

Other than for share-based payment awards, in what circumstance would dividends on a participating security be recognized in earnings?

Interpretive response: Distributions may be reflected in income (loss) if the participating security is not itself classified as equity – i.e. a payment of dividends to participating debt would generally appear as an expense on the income statement.

Question 5.3.30

Should income be adjusted if the distributions exceed net income?

Interpretive response: Yes. The adjustment to income reflects all distributions for the period even when the distributions exceed the net income for the period. See also section 5.3.20 and Question 5.5.40.

Question 5.3.40

How is income adjusted for temporary equity-classified common shares redeemable at other than fair value?

Interpretive response: As discussed in Question 3.3.20, redeemable common shares include an in-substance preferential distribution, when the redemption amount is greater than fair value (e.g. for a fixed price). Increases or decreases in the carrying amount of the redeemable instrument are reflected in EPS using the two-class method.

We believe there are two acceptable approaches for adjusting income for the increases or decreases in the redemption price, which would be reflected as allocated earnings under the two-class method to these instruments.

— **Approach A (Gross changes approach).** Treat the entire change in the instrument's carrying amount as being like a dividend; or

— **Approach B (Kicker approach).** Treat only the portion of the change in the instrument's carrying amount that reflects a redemption in excess of fair value as being like a dividend.

Under either approach, an entity reflects decreases in the instrument’s carrying amount only to the extent they represent recoveries of cumulative increases previously reflected in applying the two-class method. [480-10-S99-3A FN17]

See Example 7.5.60 in KPMG Handbook, Consolidation, for an illustration of common shares redeemable at other than fair value, including EPS considerations.

Question 5.3.45

Is there an adjustment for dividends on liability-classified instruments when adjusting income from continuing operations for earnings distributed?

Interpretive response: No. Dividends on liability-classified instruments (e.g. convertible debt) are not allocated when adjusting income from continuing operations for earnings distributed; this is because the dividends are already charged against income. Deducting those dividends would result in double counting them in calculating income available to common shareholders.

Question 5.3.47
If a distribution may be received in shares or in cash, how is a dividend in shares treated when applying the two-class method?

Background: Sometimes an entity (e.g. a REIT) will distribute a fixed dollar amount to its shareholders with the option to receive their entire distribution in cash, or shares of equivalent value – but with a potential limitation on the total amount of cash that shareholders can elect to receive in the aggregate (e.g. for tax reasons or legal authorization requirements).

Interpretive response: The entity allocates the REIT shares, when distributed, in the same manner as cash dividends; the share distribution is not considered a stock dividend but is reduced from the numerator in the two-class method. See Question 7.3.20. [505-20-15-3A]

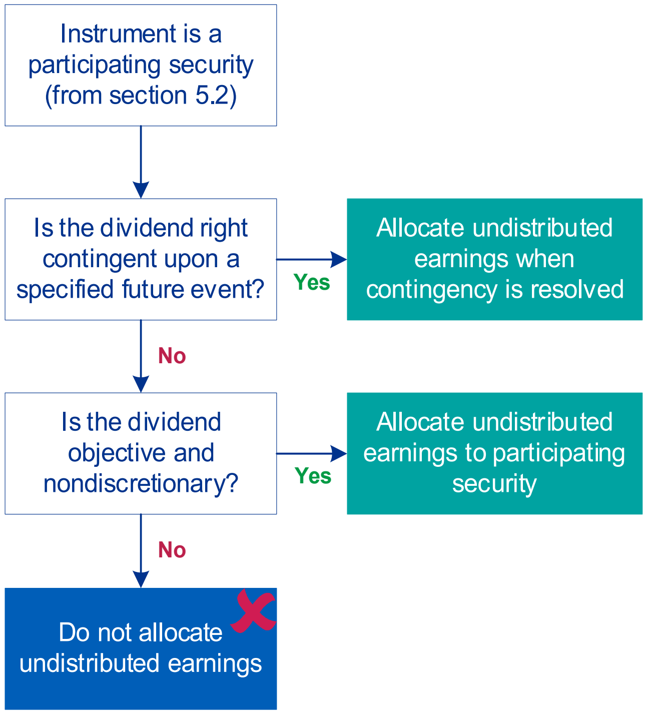
5.3.20 Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

The remaining earnings (i.e. the undistributed earnings) are notionally allocated to common shares and participating securities according to the terms of each security (to the extent that each security may share in earnings). The allocation is made assuming that all of the earnings for the period had been distributed, even if there is no intention to distribute such earnings. [260-10-45-60B(b), 45-66]

Undistributed earnings are allocated based on the contractual rights of the instrument to participate in earnings. For example, if the instrument participates on a one-to-one basis, the undistributed earnings are allocated on that basis. [260-10-45-65, 55-25]

Undistributed earnings are allocated to a participating security only if the participation rights, based on the terms of the instrument, are objectively determinable and nondiscretionary. For example, if the extent of the participation rights is based on a future board decision, they are not objectively determinable, and only the distributed earnings (if any) are allocated, but not the undistributed earnings (see section 5.6). [260-10-45-65, 55-27, 55-29]

The following flowchart is useful in determining whether to allocate undistributed earnings to a participating security.



Observation
Notional allocation of undistributed earnings

The allocation of undistributed earnings is unusual in that it is pro forma in nature and is made without regard to the entity's intention or past experience of distributing earnings. [260-10-45-66]

Example 5.3.20
Allocating undistributed earnings to participating securities

Assume the same facts as in Example 5.3.10.

Step B: Notionally allocate remaining earnings to the different classes of securities

	Class X shares (participating equity instruments)	Class Y shares (common shares)
Shares outstanding	100	100
Remaining earnings allocated to each class of security	$700 [1,400 × 100 ÷ 200]	$700 [1,400 × 100 ÷ 200]

Question 5.3.50

How does an entity determine the number of participating securities to use to allocate earnings?

Interpretive response: We believe that, in general, undistributed earnings should be allocated to participating securities based on the weighted-average number of participating securities outstanding during the period.

Question 5.3.55

How do dividends on participating preferred shares affect the allocation of undistributed earnings in Step B of the two-class method?

Interpretive response: Similar to the response in Question 5.3.15 related to Step A, for Step B preferred share dividends affect the allocation of undistributed earnings to participating securities differently, depending on whether the preferred share dividends are cumulative or noncumulative.

Cumulative dividends

The full amount of the cumulative dividend for the period is considered distributed in Step A of the two-class method, regardless of whether the dividend was actually declared during the period (see Question 5.3.15). Therefore, because all of the dividends are accounted for in the distributed earnings allocation, cumulative preferred dividends have no effect on undistributed earnings.

Noncumulative dividends

The effect of noncumulative dividends on the distributed earnings allocation depends on whether the dividends were declared during the period.

— Dividends declared during the period are considered distributed and allocated in Step A of the two-class method (see Question 5.3.15). Therefore, because all of the dividends are accounted for in the distributed earnings allocation, declared noncumulative preferred dividends have no effect on undistributed earnings.

— For dividends not declared during the period (or declared but less than the stated dividend, resulting in undeclared dividends), undistributed earnings are allocated to the preferred shares up to the amount of the undeclared stated dividend. See Question 5.3.57 for when undeclared stated dividends exceed undistributed earnings.

Once the effect of the cumulative and noncumulative dividends on preferred shares are considered in Step B, any other remaining undistributed earnings are allocated to participating securities (including the preferred shares) and common shares based on the participating securities' contractual rights to participate in undistributed earnings, as described in this section.

Question 5.3.57

How does an entity allocate undeclared noncumulative dividends that exceed undistributed earnings for the period?

Interpretive response: As described in Question 5.3.55, when there are noncumulative dividends on preferred shares, the undistributed earnings are first allocated to the preferred shares up to the amount of the undeclared stated dividend. However, in contrast to *declared* noncumulative dividends – and cumulative dividends (whether or not declared) – if the amount of the undeclared stated dividend exceeds available undistributed earnings, the dividend is allocated only up to the amount of available earnings.

Because there is no obligation to pay noncumulative preferred dividends that are not declared, an undistributed loss to the common shareholders is not created in Step B (see Question 5.3.15). [260-10-45-60B]

Example 5.3.25

Allocating undistributed earnings to noncumulative participating preferred stock

ABC Corp. has two classes of shares, X and Y, with the following rights:

— Holders of Class X shares, which have a total par value of $1,000, are entitled to a 5% noncumulative dividend per share, and have the right to participate with common shares in any additional dividends declared. Additional dividends are discretionary, but the holders of Class X shares must receive their dividend before any payments can be made on Class Y shares.

— Holders of Class Y shares participate equally with holders of Class X shares with respect to any additional discretionary dividends only.

— Both classes of shares participate equally in residual assets upon liquidation.

The following information is also relevant.

— Net income for the period: $2,500
— ABC has not paid or declared any dividends during the period.
— Number of shares outstanding for the year: 1,000 (Class X and Class Y).

ABC concludes that the Class Y shares are the only common shares for which EPS disclosure is required (see section 5.2). ABC considers Class X shares to be participating securities.

Class X shares are not common shares because the fixed entitlement creates a preference over the Class Y shares, and the holders of Class Y shares are subordinate to the holders of Class X shares. The Class X shares are considered preferred shares, and the earnings entitlement of Class X shares has to be adjusted in arriving at the numerator for basic EPS for Class Y shares.

Step A: Adjust income from continuing operations for earnings distributed

No adjustment is necessary because no earnings were distributed. Because the Class X shares are noncumulative, they are not considered distributed until declared.

Step B: Notionally allocate remaining earnings to the different classes of securities

	Class X shares (participating equity instruments)	Class Y shares (common shares)
Shares outstanding	100	100
Remaining earnings allocated to each class of security	$1,275 [$50[1] + ($2,450[2] × 100 ÷ 200)]	$1,225 [$2,450[2] × 100 ÷ 200]

Notes:

1. Dividend on noncumulative preferred shares [$1,000 × 5%]
2. $2500 – $50 [5% noncumulative dividend]

Question 5.3.60

How does an entity allocate earnings to share-based payment awards that are participating securities?

Interpretive response: How an entity allocates undistributed earnings to share-based payment awards that are participating securities depends on whether it estimates forfeitures or accounts for forfeitures only when they occur.

— An entity that elects to account for forfeitures when they occur allocates undistributed earnings to all awards outstanding during the period on the basis of their participation rights. [260-10-45-68B]

— An entity that chooses to estimate forfeitures should use actual outstanding awards less estimated forfeitures when determining the number of outstanding participating securities for which to calculate EPS under the two-class method. A change in estimated forfeitures is accounted for in the period in which the change occurs. Prior-period EPS calculations are not retrospectively adjusted. [260-10-45-68B]

See Case D in Topic 260's Example 9 in the Select Topic 260 illustrations section at the end of this Handbook (paragraphs 260-10-55-76A – 55-76D).

Question 5.3.70

How does an entity that distributes earnings based on a waterfall structure allocate its undistributed earnings?

Background: Some entities distribute earnings based on a waterfall structure, whereby a class of preferred shares may first receive cumulative dividends and then additional distributions up to the amount of its investment, before dividends are distributed to other classes.

Interpretive response: We believe that when calculating EPS under the two-class method, before allocating undistributed earnings, cumulative dividends should be allocated to all securities that are entitled to them. Remaining undistributed earnings should then be allocated to *all* participating securities based on their entitlement.

A waterfall provision that distributes earnings first to a particular security, up to the amount invested, serves as a cap. While undistributed earnings would be allocated to *all* participating securities, the existence of a cap in an instrument would limit the allocation to that instrument to the amount funded.

Question 5.3.80

How does an entity allocate its undistributed earnings when participating securities were outstanding for only a portion of the period?

Interpretive response: As discussed in Question 8.3.50, Topic 260 does not specify how to apply the two-class method to interim year-to-date periods.

When a participating security is outstanding for part of a period (i.e. issued or redeemed in the period) we believe that income should be allocated using the weighted-average number of participating securities outstanding during the period. This is done even if the class of participating securities is no longer outstanding by period end – i.e. it will never receive a distribution of these earnings.

Observation

Total earnings allocated equals reported net income

When allocating earnings under the two-class method, the sum of all earnings allocated (distributed and undistributed) should equal net income reported in the income statement. This is because any adjustments to net income available to common shareholders are reflected in the earnings allocated to the participating securities.

5.3.30 Step C: Determine total earnings allocated to each class of instrument

The result of Steps A and B is that total earnings allocated to each class of common stock is the sum of: [260-10-45-60B(b)]

Earnings distributed or accumulated[1] to participating security [Step A] + **Remaining earnings allocated to participating security [Step B]** = **Total earnings attributable to each class of participating security [Input to step C]**

Note:

1. Includes undistributed earnings, e.g. cumulative unpaid dividends.

Example 5.3.30
Determining total earnings allocated

Step C: Determine total earnings allocated to each class of instrument

The following allocation continues from Example 5.3.20.

	Class Y
Dividends paid (from Step A)	$ 500
Remaining earnings (from Step B)	700
Total earnings attributable to security	**$ 1,200**

EPS is not calculated for Class X shares because they are not considered common shares.

5.3.40 Step D: Divide total earnings allocated to each class of common shares by weighted-average number of shares outstanding for the period

Total earnings allocated to the common shares is then divided by the weighted-average number of shares outstanding for that security for the period. The result is the EPS attributable to common shares. [260-10-45-60B(c)]

Example 5.3.40
EPS for common shares after allocating earnings to participating securities

Step D: Divide total earnings allocated to common shares by weighted-average number of shares outstanding for the period

The following calculation continues from Example 5.3.30.

	Class Y
Total earnings attributable to security	$ 1,200
Weighted-average number of shares outstanding	100
Basic EPS	**$ 12.00**

As noted in Step C, EPS is not calculated for Class X shares because they are not considered common shares.

5.3.50 Illustration of basic EPS under the two-class method

Example 5.3.50
EPS calculation with two classes of common shares

ABC Corp. has two classes of common shares, X and Y.

Holders of Class X shares participate in dividends at a rate of 1% more than holders of Class Y shares.

The following additional facts are relevant.

- Net income for the period: $100,000.
- ABC did not declare or pay any dividends for the period.
- Number of ABC's shares outstanding for the period: 30,000 for Class X and 10,000 for Class Y.

Basic EPS calculation

Step A: Adjust income from continuing operations for earnings distributed

There were no dividends declared or paid in the period so no adjustment is necessary.

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

In the following calculation, Z represents the dividend per share to holders of Class B shares. The undistributed net income is attributable to the holders of the two classes as follows.

	Class X	Class Y
(Z × 10,000) + (Z × 1.01 × 30,000) = $100,000		
Z = $2.48 (rounded)		
Weighted-average number of shares outstanding	30,000	10,000
Total earnings allocated to each class of security	$75,186 [$2.48 × 1.01 × 30,000]	$24,814 [$2.48 × 10,000]

Step C: Determine total earnings allocated to each class of instrument

There are no dividends declared or paid in the period and therefore no adjustments from Step A to be added to the amounts calculated in Step B.

Therefore, total earnings are allocated to each class of participating security as follows.

	Class X	Class Y
Distributed earnings	–	–
Remaining earnings	$75,186	$24,814
Total earnings allocated to each class of shares	**$75,186**	**$24,814**

Step D: Divide total earnings allocated to each class of common shares by number of weighted-average outstanding shares for the period

	Class X	Class Y
Total earnings allocated to each class of security	$75,186	$24,814
Weighted-average number of shares outstanding	30,000	10,000
Basic EPS	**$ 2.51**	**$ 2.48**

5.4 Presentation of EPS under the two-class method

Basic and diluted EPS is required for all classes of common shares only. An entity may, but is not required to, present EPS for participating securities. In our experience, entities typically do not present EPS for participating securities. [260-10-45-60, 45-60B(d)]

Question 5.4.10

Is EPS required to be presented for each class of common shares even when EPS is identical for each of the classes?

Interpretive response: Yes. We believe paragraph 260-10-45-60B(d) requires basic and diluted EPS data to be presented for each class of common shares even when basic and diluted EPS are identical for each class of common shares.

An entity may separately disclose the basic and diluted EPS for each class of common shares on the face of the income statement, or may disclose one basic and diluted number and clearly indicate that it applies to multiple classes of common shares – e.g. basic net income (loss) per share of Class X and Y common shares. However, in the notes to the financial statements, an entity should provide all required quantitative disclosures for each class of common shares separately and also disclose qualitatively that EPS is identical for each class of common shares under the two-class method.

5.5 Allocating losses under the two-class method

Excerpt from ASC 260-10

• > Participating Securities and the Two-Class Method

45-67 An entity would allocate losses to a nonconvertible participating security in periods of net loss if, based on the contractual terms of the participating security, the security had not only the right to participate in the earnings of the issuer, but also a contractual obligation to share in the losses of the issuing entity on a basis that was objectively determinable. Determination of whether a participating security holder has an obligation to share in the losses of the issuing entity in a given period shall be made on a period-by-period basis, based on the contractual rights and obligations of the participating security. The holder of a participating security would have a contractual obligation to share in the losses of the issuing entity if either of the following conditions is present:

a. The holder is obligated to fund the losses of the issuing entity (that is, the holder is obligated to transfer assets to the issuer in excess of the holder's initial investment in the participating security without any corresponding increase in the holder's investment interest).
b. The contractual principal or mandatory redemption amount of the participating security is reduced as a result of losses incurred by the issuing entity.

45-68 A convertible participating security should be included in the computation of basic EPS in periods of net loss if, based on its contractual terms, the convertible participating security has the contractual obligation to share in the losses of the issuing entity on a basis that is objectively determinable. The guidance in this paragraph also applies to the inclusion of convertible participating securities in basic EPS, irrespective of the differences that may exist between convertible and nonconvertible securities. That is, an entity should not automatically exclude a convertible participating security from the computation of basic EPS if an entity has a net loss from continuing operations. Determination of whether a participating security holder has an obligation to share in the losses of the issuing entity in a given period shall be made on a period-by-period basis, based on the contractual rights and obligations of the participating security.

Securities other than common shares generally do not share in the losses of an entity. Therefore, in a period of net loss, an entity does not automatically allocate the losses to all participating securities to which it allocates income. The condition for allocating net losses to a participating security is if the instrument's holder has an objectively determinable contractual obligation to share in the entity's losses. This determination is made each period. This means that an entity may allocate losses to the instrument in one period, and not allocate losses to the same instrument in a different period. [260-10-45-67]

A convertible instrument may also have an unconditional obligation to participate in the entity's losses. Therefore, a convertible instrument should not be automatically excluded from the allocation of losses. The terms of a convertible instrument should be evaluated in each period of loss, similar to any other participating security, to determine if the instrument's holder has an unconditional obligation to participate in the entity's losses. [260-10-45-68]

Question 5.5.10

What are some indicators that the holder of a participating security has an unconditional obligation to share in an entity's losses?

Interpretive response: The following conditions are some indicators that the holder of a participating security has an unconditional obligation to share in the entity's losses. [260-10-45-67]

— The holder is obligated to fund the entity's losses. This means the holder has an obligation to transfer assets to the entity that exceed the holder's investment and for which the holder would obtain no additional investment interest.

— The entity's losses result in a reduction of the contractual principal (for a debt security) or the mandatory redemption amount (for a mandatorily redeemable instrument).

Observation

Inconsistency between allocating income and losses in the two-class method

Under the two-class method, a participating security may receive an earnings allocation when there are earnings, but not an allocation of losses in periods of loss (unless contractually obligated to share in the losses). While this may seem like an inconsistent approach, it aligns with the instrument's rights and obligations. Further, this approach provides for the greatest dilution to the common shareholders.

Observation
Undistributed loss allocated to common shareholders may be greater when dividends are declared

In periods of net loss, any earnings distributed to a participating security holder (i.e. dividends declared) result in an undistributed net loss in excess of the entity's reported net loss. Unless a participating security has a contractual obligation to share in the losses of the issuing entity, the entire undistributed net loss is allocated to the common shares. [260-10-45-67 – 45-68]

The result of applying this guidance is that in periods of net loss, dividends declared that are payable to the participating security holder increase the loss per share applicable to the common shareholders.

Example 5.5.10
Applying a net loss to participating securities under the two-class method

The following facts apply to ABC Corp.

Common shares:

- 1,000 weighted-average common shares outstanding during the period.
- ABC paid a dividend of $0.50 per common share during the period, for a total of $500: $0.50 ×100.

Participating forwards:

- There are 100 weighted-average participating forwards outstanding during the period.
- The forwards participate in dividends on a 1:1 basis with common shares. Therefore, ABC paid $50 in dividends to forward holders during the period: $0.50 ×100.
- The forwards have no contractual obligation to share in losses.

ABC incurred a net loss of $10,000 during the period.

Basic EPS calculation

Step A: Adjust income from continuing operations for earnings distributed

Net loss		$(10,000)
Less: Dividends declared		
Common shares	(500)	
Participating securities	(50)	
Total		**(550)**
Remaining loss		**$(10,550)**

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

The entire undistributed loss of $10,550 is allocated to the common shareholders because the forwards have no contractual obligation to share in losses.

Step C: Determine total earnings allocated to each class of instrument

	Participating forwards	Common shares
Distributions declared	$50	$ 500
Remaining earnings (loss)	–	(10,550)
Total earnings (loss) allocated to each class of security	**$50**	**$(10,050)**

Step D: Divide total earnings allocated to each class of common shares by number of weighted-average outstanding shares for the period

The following are the basic EPS amounts for the participating forwards and common shares.

	Participating forwards[1]	Common shares
Total earnings (loss) allocated to each class of security	$ 50	$(10,050)
Weighted-average number of instruments outstanding	100	1,000
Basic EPS[1]	**$0.50**	**$ (10.05)**

Note:

1. An entity is only required to present EPS amounts for outstanding common shares. It is permitted, but not required, to present EPS amounts for participating securities.

The conclusions in this example are consistent with the guidance in paragraph 260-10-55-106, which addresses circumstances in which an MLP makes distributions in excess of its earnings for a period (see section 9.3).

Question 5.5.20

Is undistributed income (or loss) allocated when there is income from continuing operations and a loss from discontinued operations, or vice versa?

Background: Undistributed losses are not allocated to participating securities under the two-class method of calculating EPS unless the participating security has a contractual obligation to share in losses on a basis that is objectively determinable. [260-10-45-67 – 45-68]

If an entity has discontinued operations, Topic 260 requires the entity to report basic and diluted EPS for (1) income or loss from continuing operations, (2) discontinued operations and (3) net income or loss. [260-10-45-2 – 45-3]

Interpretive response: Topic 260 does not directly address this question. However, we believe that undistributed income or loss should be allocated to participating securities under the two-class method if the entity in its entirety (including both continuing operations and discontinued operations) has *net undistributed income* for the period.

If the entity in its entirety has net undistributed income for the period, it allocates an undistributed loss to the participating securities with respect to the EPS calculation for the component of the entity's operations (i.e. either continuing operations or discontinued operations) that has the undistributed loss.

In contrast, if the entity in its entirety (including both continuing operations and discontinued operations) has a *net undistributed loss* for the period, it does not allocate undistributed income to the participating securities with respect to the EPS calculation for the component of the entity's operations (i.e. either continuing operations or discontinued operations) that has undistributed income.

Note: This is consistent with the guidance on applying the two-class method in paragraph 260-10-45-60B(b), which specifies that, after deducting dividends declared or accumulated as discussed in paragraph 260-10-45-60B(a), the "remaining earnings shall be allocated to common shares and participating securities to the extent that each security may share in earnings *as if all of the earnings for the period had been distributed*." [emphasis added] Absent any rounding differences, applying this guidance results in EPS from continuing operations plus EPS from discontinued operations equaling net income (loss) per share.

Example 5.5.20

Allocating undistributed income/loss to participating securities under the two-class method with income from continuing operations and a loss from discontinued operations

For the following scenarios, ABC Corp. has a participating security that requires applying the two-class method, and holders of that security do not have a contractual obligation to share in losses on a basis that is objectively determinable.

ABC has declared $1,000 of dividends to holders of common shares and participating securities, and no preferred share dividends have been declared or have accumulated for the reporting period.

	Scenario A	Scenario B	Scenario C	Scenario D
Income/(loss) – continuing ops	$ (2,400)	$ 2,400	$ (2,400)	$ 2,400
Less: Dividends declared	(1,000)	(1,000)	(1,000)	(1,000)
Undistributed income/ (loss) – continuing ops	**$ (3,400)**	**$ 1,400**	**$ (3,400)**	**$ 1,400**

	Scenario A	Scenario B	Scenario C	Scenario D
Income/(loss) – discontinued ops	3,600	3,600	(3,600)	(3,600)
Undistributed net income/(loss)	**$ 200**	**$ 5,000**	**$ (7,000)**	**$ (2,200)**

In Scenarios C and D, ABC in its entirety has net undistributed losses ($7,000 and $2,200 net undistributed losses, respectively). It does not allocate any undistributed amounts to the participating securities in calculating EPS from continuing operations and discontinued operations in either of those scenarios – i.e. all undistributed amounts are allocated to the common shareholders.

In applying this treatment to Scenario D, all undistributed amounts are allocated to the common shareholders for EPS purposes even though ABC has $1,400 of undistributed income from continuing operations.

In scenarios A and B, ABC in its entirety has undistributed net income ($200 and $5,000 net undistributed income, respectively). It allocates the undistributed amounts between the common shareholders and the participating security holders in calculating EPS from continuing operations and discontinued operations for both of those scenarios.

In applying this treatment to Scenario A, all undistributed amounts are allocated between the common shareholders and participating security holders under the two-class method for EPS purposes even though ABC has a $3,400 undistributed loss from continuing operations.

As mentioned in Question 5.5.20 the result is consistent with the guidance on applying the two-class method in paragraph 260-10-45-60B(b).

Question 5.5.30

Does a reduction in a liquidation preference of a participating security or in the entity's ability to pay dividends require an allocation of losses to the security?

Interpretive response: No. A holder is not obligated to share in the losses of the issuing entity solely because the losses reduce the holder's liquidation preference or reduce the issuing entity's ability to pay dividends to the participating security holder in the future.

Question 5.5.40

How should an entity with participating securities apply the two-class method when dividends declared exceed net income for the period?

Background: Paragraph 260-10-45-60B specifies that the total earnings allocated to common shares and a participating security be determined by adding the amount allocated for dividends and the amount allocated for a participation feature. However, paragraph 260-10-45-67 specifies that an issuing entity should not allocate losses to a participating security unless the contractual terms of that security specify that the security has a contractual obligation to share in the losses of the issuing entity.

Interpretive response: For periods in which dividends declared exceed net income, we believe an entity should allocate the resulting *undistributed net loss* entirely to the common shares – unless the participating security is contractually obligated to share in losses on a basis that is objectively determinable based on the guidance in paragraph 260-10-45-67.

This conclusion is consistent with the guidance in paragraph 260-10-55-106, written in the context of MLPs, in which any excess of distributions over earnings are allocated to the IDRs to the extent that they share in the losses; otherwise the excess would not be allocated to the IDRs. However, we believe the guidance on the EPS treatment of dividends declared in excess of net income with respect to participating securities is consistent with paragraph 260-10-45-67 and should be applied regardless of whether the entity is a MLP (see section 9.3). We believe this guidance also applies to participating share-based payment awards.

See also Questions 5.3.15 and 5.3.57.

Example 5.5.30

Earnings allocation when dividends declared exceed net income

The following facts apply to ABC Corp.

Common shares:

— 1,000 weighted-average common shares outstanding during the period.
— ABC paid a dividend of $0.50 per common share during Year 1, for a total of $500: $0.50 ×1,000.

Participating forwards:

— 100 weighted-average participating forwards outstanding during Year 1.
— The forwards participate in dividends on a 1:1 basis with common shares.
— Therefore, ABC paid $50 in dividends to forward holders during Year 1: $0.50 ×100.
— The forwards have no contractual obligation to share in losses.

ABC had net income of $300 during Year 1.

Basic EPS calculation – Year 1

Step A: Adjust income from continuing operations for earnings distributed

Net income		$300
Less: Dividends declared		
Common shares	(500)	

Participating securities	(50)	
Total		**(550)**
Remaining loss		**$(250)**

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

The entire undistributed loss of $250 is allocated to the common shareholders because the forwards have no contractual obligation to share in losses.

Step C: Determine total earnings allocated to each class of instrument

	Participating forwards	Common shares
Dividends declared	$50	$500
Remaining loss	–	(250)
Total earnings allocated to class of security	**$50**	**$250**

Step D: Divide total earnings allocated to each class of common shares by number of weighted-average outstanding shares for the period

The following are the basic EPS amounts for the participating forwards and common shares.

	Participating forwards	Common shares
Total earnings allocated to class of security	$ 50	$ 250
Weighted-average number of instruments outstanding	100	1,000
Basic EPS[1]	**$0.50**	**$0.25**

Note:

1. An entity is only required to present EPS amounts for outstanding common shares. It is permitted, but not required, to present EPS amounts for participating securities.

Question 5.5.50

How should losses be allocated to classes of common shares that have different dividend participation rights but share equally in residual net assets?

Interpretive response: We believe that if different classes of common shares have different dividend participation rights, but share equally in the residual net assets of the entity, then undistributed losses should be allocated equally to the different classes of common shares.

Question 5.5.60

Should losses be allocated to restricted stock?

Interpretive response: It depends. While vested restricted stock may share in residual net assets through fluctuations in the stock price, unvested restricted stock does not. This is because unvested restricted stock is not considered outstanding, even though it may be a participating security (see section 6.8.20). Therefore, we believe that losses should be allocated to vested restricted stock but not to unvested restricted stock.

5.6 Other participation rights considerations

Excerpt from ASC 260-10

• > Participating Securities and Undistributed Earnings

55-24 In all of the following circumstances, the participation rights of the securities may be required to be disclosed in accordance with the provisions of Subtopic 505-10, regardless of whether undistributed earnings are allocated to the **participating security**.

55-26 If a participating security provides the holder with the ability to participate with the holders of common stock in dividends declared contingent upon the occurrence of a specified event, the occurrence of which is subject to management discretion or is not objectively determinable (for example, liquidation of the entity or management determination of an extraordinary dividend), then the terms of the participating security do not specify objectively determinable, nondiscretionary participation rights; therefore, undistributed earnings would not be allocated to the participating security.

55-27 If a participating security provides the holder with the ability to participate with the holders of common stock in earnings for a period in which a specified event occurs, regardless of whether a dividend is paid during the period (for example, achievement of a target market price of a security or achievement of a certain earnings level), then undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. Undistributed earnings would be allocated to the participating security if the contingent condition would have been satisfied at the reporting date, irrespective of whether an actual distribution was made for the period.

55-28 If a participating security provides the holder with the ability to participate in extraordinary dividends and the classification of dividends as extraordinary is predetermined by a formula, for example, any dividend per common share in excess of 5 percent of the current market price of the stock is defined as extraordinary, then undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. If earnings for a given period exceed the specified threshold above which the participating security would participate (that is, earnings for the period are in excess of 5 percent of the current market price of the stock), undistributed earnings would be allocated to the participating security according to its terms.

55-29 If a participating security provides the holder with the ability to participate in extraordinary dividends and the classification of dividends as extraordinary is within the sole discretion of the board of directors, then undistributed earnings would be allocated only to common stock. Since the classification of dividends as extraordinary is within the sole discretion of the board of directors, undistributed earnings would not be allocated to the participating security as the participation in the undistributed earnings would not be objectively determinable.

55-30 If a participating security provides the holder with the ability to participate in all dividends up to a specified threshold (for example, the security participates in dividends per common share up to 5 percent of the current market price of the stock), then undistributed earnings would be allocated to common stock and the participating security based on the assumption that all of the earnings for the period are distributed. In this example, undistributed earnings would be allocated to common stock and to the participating security up to 5 percent of the current market price of the common stock, as the amount of the threshold for participation by the participating security is objectively determinable. The remaining undistributed earnings for the period would be allocated to common stock.

55-31 See Example 9 (paragraph 260-10-55-71) for an illustration of this guidance.

Certain securities may be considered participating securities (in accordance with section 5.2), and yet not have undistributed earnings allocated to them. This is because Topic 260 requires allocating earnings only if the participation rights are objectively determinable and nondiscretionary. Undistributed earnings are not intended to be allocated based on arbitrary assumptions. Further, if an entity could avoid distributing earnings to a particular participating security even if all of the earnings for the year were distributed, no allocation of earnings is made to that participating security. [260-10-45-65]

The following table illustrates specific terms of participating securities described in Topic 260 and whether undistributed earnings should be allocated to them.

Terms of security	Should undistributed earnings be allocated?	Rationale
Participates in dividends declared contingent on the occurrence of a specified event, the occurrence of which is subject to management discretion or is not objectively determinable – e.g. liquidation of the entity or management determination of an extraordinary dividend. [260-10-55-26]	No.	The terms of the participating security do not specify objectively determinable, nondiscretionary participation rights.

Terms of security	Should undistributed earnings be allocated?	Rationale
Participates in earnings for a period in which a specified event occurs, regardless of whether a dividend is paid during the period; for example, achievement of a target market price of a security or achievement of a certain earnings level – e.g. if revenues reach $500 million, instrument holder will receive a distribution of earnings. [260-10-55-27]	Yes, if the contingent condition is satisfied at the reporting date, and regardless of whether an actual distribution was made for the period.	Rights are objectively determinable and nondiscretionary. Contingency was met at period-end, and EPS is based on the assumption that all of the earnings for the period are distributed.
Participates in extraordinary dividends and the classification of dividends as extraordinary is predetermined by a formula – e.g. any dividend per common share in excess of 5% of the current market price of the shares is defined as extraordinary. [260-10-55-28]	Yes, if earnings for a given period exceed the specified threshold above which the participating security would participate – i.e. earnings for the period are in excess of 5% of the current market price of the shares.	Rights are objectively determinable and nondiscretionary. Threshold was met during the period, and EPS is based on the assumption that all of the earnings for the period are distributed.
Participates in extraordinary dividends and the classification of dividends as extraordinary is within the sole discretion of the board of directors. [260-10-55-29]	No.	The terms of the participating security do not specify objectively determinable, nondiscretionary participation rights.
Participates in all dividends up to a specified threshold – e.g. the security participates in dividends with common share up to 5% of the current market price of the shares. [260-10-55-30]	Yes, up to the amount of the threshold (in this case, 5% of the current market price of the common shares). The remaining undistributed earnings for the period are allocated to common shares.	The amount of the threshold for participation by the participating security is objectively determinable and nondiscretionary (see Question 5.2.30).

There are disclosure requirements in Subtopic 505-10 (equity) for participating securities, and depending on whether the participating security has distributed or undistributed earnings, there are incremental disclosure requirements under Topic 260 – see section 9.2.

Question 5.6.10
Should earnings be allocated to a participating security with a contingent participation right?

Interpretive response: It depends. As discussed in section 5.2, a contingent participation right may result in a participating security.

For earnings to be allocated to a participating security, the participating security's terms must specify objectively determinable, nondiscretionary participation rights. If those objectively determinable, nondiscretionary rights are contingent on a specified event (e.g. attaining a certain share price), an allocation of earnings is made to those securities in periods in which the contingent event would be satisfied as of the reporting date. This is irrespective of whether distributions actually occurred (see Question 5.2.20). [260-10-55-27]

Question 5.6.20
Should dividends potentially payable on restricted stock share-based payment awards be used to calculate EPS when debt covenants prevent the distribution of dividends?

Background: ABC Corp. grants to its employees shares of restricted stock, which provide the holder with the right to participate in dividends with common shareholders on a one-for-one basis, regardless of whether the restricted stock is vested. ABC will be noncompliant with debt covenants if it distributes dividends.

Interpretive response: Yes. Share-based payment awards (including restricted stock) that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and included in the calculation of EPS under the two-class method. [260-10-45-61 – 45-61A]

Although the debt covenant makes the distribution of dividends unlikely, it does not eliminate the restricted share's contractual right to participate in distributions. Further, the presumption of the two-class method is that all earnings will be distributed. Therefore, the dividends that would be distributed to share-based payment award holders in this instance are included in the EPS calculations. [260-10-45-66]

5.7 Diluted EPS calculation under the two-class method

The calculation of diluted EPS under the two-class method is similar to the calculation of basic EPS, except that it includes the effects of potential common shares. The income adjustments to arrive at diluted EPS (discussed in chapter 4) are made to each class of security based on the earnings allocated to the securities in that class. [260-10-45-60B(d)]

Undistributed earnings are allocated to *all* share-based payment awards. This includes those that are not expected to vest (for entities that estimate forfeitures) and awards that were forfeited during the period (for entities that don't estimate forfeitures), for the period those awards were outstanding. [260-10-45-68B]

Question 5.7.10

How is diluted EPS calculated when there are potential common shares that are also participating securities?

Background: Topic 260 requires that potential common shares be reflected in diluted EPS using the treasury stock method or the if-converted method, if the effect is dilutive. Under these methods, the potential common shares are assumed exercised or converted into common shares (or issued, for contingently issuable shares). Antidilutive participating securities subject to any of these methods are therefore not included in diluted EPS.

Interpretive response: When calculating diluted EPS, the ordering rules of Topic 260 (antidilution sequencing) require that each issue of potential common shares be considered in sequence from the most dilutive to the least dilutive (see section 4.5).

We believe that potential common shares that are also participating securities should be included in diluted EPS using the more dilutive of the treasury stock method or the if-converted method, as applicable, and the two-class method. If there is a contingency, the contingency is evaluated first using the contingent share guidance in Topic 260, before applying the treasury stock method or if-converted method (see sections 6.10 and 6.11).

Observation

The two-class method may be more dilutive than diluted EPS

Using the two-class method for diluted EPS may be more dilutive than using the treasury stock or if-converted methods. For example, participating securities that share in dividends on a 1:1 basis with common shares, applying the treasury stock method will always be antidilutive compared to a basic EPS calculation that allocates earnings to those participating securities under the two-class method.

Question 5.7.20

How is diluted EPS calculated when there are several classes of common shares and potential common shares that are participating securities?

Interpretive response: The response to Question 5.7.10 indicates that a method other than the two-class method (i.e. the treasury stock method, if-converted method, or contingent issuance method, whichever is applicable) is used when calculating diluted EPS, even when the potential common shares are participating securities, if that other method yields more dilutive results.

When the entity has participating securities in addition to several classes of common shares, we believe the entity should:

- apply the treasury stock method, if-converted method, or contingent issuance method (whichever is applicable) to the potential common shares; and then
- apply the two-class method to the different classes of common shares.

Question 5.7.30

How are earnings allocated for diluted EPS under the two-class method when it includes a participating security?

Interpretive response: Topic 260 does not provide an example of calculating diluted EPS under the two-class method. However, in its August 2008 Exposure Draft of FAS 128R (which was not finalized), the FASB included guidance on calculating diluted EPS under the two-class method.

That guidance indicated that undistributed earnings allocated away from common shareholders in the basic EPS calculation should be reversed and then reallocated to each class of common or potential common shares and participating securities that are assumed to be outstanding for the period.

Although this 'reallocation method' described in the Exposure Draft was not finalized, we believe an entity may choose to elect either the 'reallocation method' (Method A, below) or the alternative method below when calculating diluted EPS under the two-class method.

- **Method A, 'Reallocation Method'.** The numerator in the diluted EPS calculation reflects the reversal of undistributed earnings allocated to participating securities in the basic EPS calculation and reallocation of undistributed earnings to the participating securities and common shares assumed to be outstanding for the period.
- **Method B.** The numerator in the diluted EPS calculation equals the numerator in the entity's basic EPS calculation.

We believe that either method represents an acceptable accounting policy that should be applied consistently.

Example 5.7.10 illustrates the calculation of basic and diluted EPS calculations for an entity with participating securities (i.e. RSUs). The example illustrates the calculation of diluted EPS when an entity elects Method A (the reallocation method), and provides a qualitative description of the calculation of diluted EPS if the entity had chosen to apply Method B.

Example 5.7.05**

Basic and diluted EPS calculations for an entity with two classes of common shares

ABC Corp. has two classes of common shares, X and Y. It also has RSUs for Class X shares. Both classes of common shares have the following rights:

— participate equally in dividends; and
— participate equally in residual assets upon liquidation.

The following information is also relevant.

— Net income for the period: $1,100
— Weighted-average number of Class X shares outstanding for the period: 1,000
— Weighted-average number of Class Y shares outstanding for the period: 100
— Weighted-average number of Class X RSUs outstanding for the period: 150
— No dividends declared
— The RSUs are not participating securities.

ABC Corp. has two classes of common shares, X and Y. It also has RSUs for Class X shares.

The following facts are relevant.

Common shares

— Weighted-average number of Class X shares outstanding for the period: 1,000.
— Weighted-average number of Class Y shares outstanding for the period: 100.
— Both classes participate equally in dividends, but no dividends have been declared.
— Both classes participate equally in residual assets upon liquidation.

Class X RSUs

— Weighted-average number of Class X RSUs outstanding for the period: 150
— The RSUs are not participating securities.

EPS calculations – Year 1

ABC is required to present EPS amounts only for outstanding common shares. Since there are two classes of common shares, ABC presents EPS for both. The following additional facts are relevant.

— The diluted EPS calculation assumes 50 incremental shares under the treasury stock method.

— ABC's accounting policy (see Question 5.7.30) is to reallocate undistributed earnings in diluted EPS.

Basic EPS calculation

Step A: Adjust income from continuing operations for earnings distributed

There were no dividends declared or paid in the period, so no adjustment is necessary.

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

	Class X	Class Y
Securities outstanding	1,000	100
Remaining earnings allocated to class of security	$1,000 [$1,100 × (1,000 ÷ 1,100)]	$100 [$1,100 × (100 ÷ 1,100)]

Step C: Determine total earnings allocated to each class of common shares and participating security

There are no dividends declared or paid in the period and therefore no adjustments from Step A to be added to the amounts calculated in Step B.

Therefore, total earnings are allocated to each class of participating security as follows.

	Class X	Class Y
Dividends	–	–
Remaining earnings allocated to class of security	$1,000	$100
Total earnings allocated to class of security	**$1,000**	**$100**

Step D: Divide total earnings allocated to each class of common shares by weighted-average number of shares outstanding for the period

	Class X	Class Y
Total earnings allocated to class of security	$1,000	$100
Weighted-average number of instruments outstanding	1,000	100
Basic EPS	**$1.00**	**$1.00**

Diluted EPS calculation (Class X)

	Undistributed and distributed earnings	Class X Shares	Class X EPS
As reported – basic EPS	$ 1,000	1,000	$ 1.00
Add back: undistributed earnings allocated to Class Y	100[1]		

	Undistributed and distributed earnings	Class X Shares	Class X EPS	
RSUs added to the denominator under the treasury stock method		50		
Less: undistributed earnings reallocated to Class Y	(96)[2]			
Subtotal	$ 1,004	1,050	$ 0.96 dilutive	✓

Notes:

1. From Step B in basic EPS calculation
2. Total undistributed earnings times Class Y securities divided by total of Class X securities, Class Y securities and incremental RSU shares under the treasury stock method: ($1,100 x (100 ÷ 1,150))

Diluted EPS calculation (Class Y)[1]

	Undistributed and distributed earnings	Class Y Shares	Class Y EPS	
As reported – basic EPS	$ 100	100	$ 1.00	
Add back: undistributed earnings reallocated to Class X	(1,000)[2]			
Less: undistributed earnings reallocated to Class X	(1,004)[3]			
Subtotal	$ 96	100	$ 0.96 dilutive	✓

Notes:

1. This illustrates distinct income allocation for Class Y, which is mathematically the same as the total of undistributed earnings less reallocation to Class X.
2. From Step B in basic EPS calculation
3. Total undistributed earnings times Class X securities after inclusion of RSUs divided by total of Class X securities, Class Y securities and incremental RSU shares under the treasury stock method: ($1,100 x (1050 ÷ 1,150))

Summary:

This example of the two-class EPS calculation highlights:

— applying the two-class method to two classes of common shares; and
— reallocating undistributed earnings in the diluted EPS calculation

This example appropriately yields the same EPS results for each class of common shares, because they share in dividends equally by their terms. However, in a similar scenario where dividends are paid for each class of share, a different diluted EPS may result as the RSUs would not have been eligible to receive the declared dividend.

If ABC's accounting policy were not to reallocate undistributed earnings in the diluted EPS calculation, diluted EPS for the Class X shares would be $0.95 ($1,000 of undistributed earnings divided by 1,050 shares, including dilutive RSU shares under the treasury stock method) and EPS for the Class Y shares would remain unchanged from basic EPS at $1.00.

Example 5.7.10

Basic and diluted EPS calculations for an entity with participating RSUs

This example relates to RSUs, but applies equally to other participating securities)

The following facts relate to ABC Corp.

Common shares:

- 1,000 weighted-average common shares outstanding during Year 1.
- ABC paid a dividend of $0.50 per common share during Year 1, for a total of $500: $0.50 × 1,000.

Options:

- 200 weighted-average options outstanding during Year 1.
- Options do not contain any dividend participation rights.

RSUs:

- 100 weighted-average RSUs outstanding during Year 1.
- Expected forfeiture rate for the unvested RSUs is 10%.
- Holders of unvested RSUs are entitled to participate in cash dividends on a 1:1 basis with holders of common shares.
- Any payments received by the RSU holders are non-forfeitable.
- Total dividends paid to unvested RSUs during Year 1 was $50, comprising the following:
  - $45 of dividends to unvested RSUs charged to retained earnings: $0.50 × 90 RSUs expected to vest.
  - $5 of dividends to unvested RSUs charged to expense: $0.50 × 10 RSUs not expected to vest.

ABC paid a total of $550 in dividends [$0.50 × (1,000 shares + 100 RSUs)].

ABC had net income of $10,000 during Year 1.

In addition, ABC's accounting policy is to reallocate the earnings attributable to participating securities in the calculation of diluted EPS, giving effect to incremental shares included in the denominator of the diluted EPS calculation.

Because of the non-forfeitable entitlement to participate in dividends with the common shares, the RSUs are participating securities. [260-10-45-61A, 45-68B]

EPS calculations – Year 1

ABC is required to present EPS amounts only for outstanding common shares. It is permitted, but not required, to present EPS amounts for participating securities. In this instance, ABC decides to present EPS amounts for participating securities. [260-10-45-60]

ABC determines basic and diluted EPS for outstanding common shares and participating RSUs below. The diluted EPS calculation assumes the following incremental shares under the treasury stock method:

- Options: 50 incremental shares
- RSUs: 20 incremental shares.

Basic EPS calculation

Step A: Adjust income from continuing operations for earnings distributed

Net income		$10,000
Less: Dividends paid		
Common shares	(500)	
RSUs expected to vest recorded in equity	(45)	
Total		**(545)**
Remaining earnings		**$ 9,455**

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

	Unvested RSUs	Common stock
Securities outstanding	100	1,000
Remaining earnings allocating to class of security	$860 [(100 ÷ (100 + 1,000)) × $9,455]	$8,595 [(1,000 ÷ (100 + 1,000)) × $9,455]

Note: Dividends on the RSUs not expected to vest are already deducted in arriving at net income.

Step C: Determine total earnings allocated to each class of instrument

	Unvested RSUs	Common stock
Dividends	$ 45	$ 500
Remaining earnings allocating to class of security	860	8,595
Total earnings allocated to class of security	**$905**	**$9,095**

Step D: Divide total earnings allocated to each class of common shares by weighted-average number of shares outstanding for the period

	Unvested RSUs[1]	Common shares
Total earnings allocated to class of security	$ 905	$9,095

	Unvested RSUs[1]	Common shares
Weighted-average number of instruments outstanding	100	1,000
Basic EPS	**$9.05**	**$ 9.10**

Note:
1. Presentation is only necessary for the common shares.

Diluted EPS calculation

	Undistributed and distributed earnings	Common shares	EPS	
As reported – basic EPS	$ 9,095[1]	1,000	$ 9.10	
Add back: undistributed earnings allocated to the RSUs	860			
Stock options added to the denominator under the treasury stock method		50		
Less: undistributed earnings reallocated to the RSUs	(822)[2]			
Subtotal	$ 9,133	1,050	$ 8.70 dilutive	✓
Add back: dividends on RSUs expected to vest	45			
Add back: undistributed earnings reallocated to the RSUs	822			
RSUs added to the denominator under the treasury stock method		20		
Diluted EPS for common shares	**$ 10,000**	**1,070**	**$ 9.35 antidilutive**	✗

Notes:
1. Net income less dividends to unvested RSUs charged to retained earnings less allocation of undistributed earnings to unvested RSUs: $10,000 – $45 – $860.
2. Undistributed earnings times RSUs divided by total of common shares, RSUs and options under the treasury stock method: ($9,455 × 100) ÷ 1,150.

ABC calculates diluted EPS for the unvested RSUs as follows.

	Undistributed and distributed earnings	Unvested RSUs	Earnings per unvested RSU
As reported – basic EPS	$ 905	100	$ 9.05
Less: undistributed earnings allocated to the RSUs	(860)		

	Undistributed and distributed earnings	Unvested RSUs	Earnings per unvested RSU
Add back: undistributed earnings reallocated to the RSUs	822[1]		
Diluted EPS – unvested RSUs	**$ 867**	**100**	**$ 8.67 dilutive** ✓

Note:

1. Undistributed earnings times RSUs divided by total of common shares, RSUs and options under the treasury stock method: i.e. ($9,455 × 100) ÷ 1,150.

Summary:

This example of the two-class EPS calculation highlights:

- applying the two-class method to share-based payment arrangements that are participating securities;
- reallocating undistributed earnings to participating securities in the diluted EPS calculation; and
- the antidilution sequencing when calculating diluted EPS.

Because the unvested RSUs are treated as participating securities (as required by paragraphs 260-10-45-61A and 260-10-45-68B), ABC appropriately applies the treasury stock method to the unvested RSUs in its diluted EPS calculation. However, the overall effect is antidilutive because diluted EPS increases from $9.10 to $9.35.

ABC's accounting policy (see Question 5.7.30) is to reallocate undistributed earnings to the RSUs (participating securities) and the common shares (including dilutive potential common shares) in the diluted EPS calculation because the denominator has an additional 50 shares from the options under the treasury stock method. The calculation results in $822 undistributed earnings allocated to the participating securities in the diluted EPS, as opposed to the $860 undistributed earnings allocated to the participating securities in the basic EPS.

If ABC's accounting policy was not to reallocate undistributed earnings to the RSUs (participating securities) and the common shares (including dilutive potential common shares) in the diluted EPS calculation, diluted EPS for the common shares would be $8.66 ($9,095 of undistributed and distributed earnings divided by 1,050 shares, including dilutive potential common shares).

Question 5.7.40

If the assumed share settlement of dilutive potential common shares moves the entity to a net loss position, should it be allocated losses under the two-class method?

Interpretive response: If the assumed share settlement of dilutive potential common shares moves the entity from a profit to a loss position, the numerator of diluted EPS is still adjusted for all contractual effects on participating securities of assumed share settlement of the instrument.

For example, this can occur when a share-settled derivative is classified as a liability and results in income during the period. If the entity has losses for diluted EPS purposes, a participating security not contractually obligated to share in losses would have no undistributed income or loss attributed to it under the two-class method when calculating diluted EPS. However, in each case, an entity should follow the rules on antidilution and sequencing (see sections 4.5 and 5.7).

Example 5.7.20

Effect of an in-the-money equity-classified participating warrant on dilutive EPS

ABC Corp. had 950 common shares outstanding during all of Year 1 as well as an equity-classified warrant to purchase 50 common shares at $5 per share.

— The holder of the warrant is entitled to cash dividends with common shareholders on a 1:1 basis – e.g. if ABC pays a dividend of $1 per share to common shareholders, the warrant holder receives a non-forfeitable $50 cash payment.

— ABC common shares have a fair value of $10 per share throughout the period and ABC earns $1,000 of net income during Year 1.

EPS calculations – Year 1

Basic EPS calculation

Step A: Adjust income from continuing operations for earnings distributed

There were no dividends declared or paid in the period so no adjustment is necessary.

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

	Warrant	Common shares
Securities outstanding	50	950
Remaining earnings allocated to class of security	$50 [$1,000 × 50 ÷ 1,000]	$950 [$1,000 – 50]

Step C: Determine total earnings allocated to each class of common shares and participating security

There are no dividends declared or paid in the period and therefore no adjustments from Step A to be added to the amounts calculated in Step B.

Therefore, total earnings are allocated to each class of participating security as follows.

	Warrant	Common shares
Dividends	–	–
Remaining earnings allocated to class of security	$50	$950
Total earnings allocated to class of security	**$50**	**$950**

Step D: Divide total earnings allocated to each class of common shares by weighted-average number of shares outstanding for the period

	Common shares
Total earnings allocated to class of security	$950
Weighted-average number of instruments outstanding	950
Basic EPS[1]	**$1.00**

Note:

1. Presentation is only necessary for the common shares.

Diluted EPS calculation

Step A: Adjust income from continuing operations (or net income) for earnings distributed

There were no dividends declared or paid in the period so no adjustment is necessary.

Step B: Notionally allocate remaining earnings to the different classes of common shares and participating securities

If the warrant holder exercised the warrant at the beginning of the period, ABC would have issued shares in satisfaction of the warrant and there would have been no participating securities outstanding during the period. All $1,000 of net income would be available to the common shareholders.

Step C: Determine total earnings allocated to each class of instrument

There are no dividends declared or paid in the period and therefore no adjustments from Step A to be added to the amounts calculated in Step B.

Step D: Divide total earnings allocated to each class of common shares by weighted-average number of shares outstanding for the period

Numerator: $1,000 (see Step B)

Denominator: 975 shares: 950 shares plus 25 dilutive shares. The 25 dilutive warrant shares are determined using the treasury stock method: 50 shares – ($5 exercise price × 50 shares ÷ $10 per share average share price) = 25 dilutive shares

Diluted EPS: $1.00 per share, which is equal to basic EPS because assumed exercise of the warrant would be antidilutive (EPS assuming exercise would be $1,000 ÷ 975 shares = $1.03 per share).

Example 6 in Topic 260 (reproduced below) illustrates the two-class method.

Excerpt from ASC 260-10

• > Example 6: Two-Class Method

55-62 This Example illustrates the two-class method of computing basic EPS (see paragraph 260-10-45-60B) for an entity that has more than one class of nonconvertible securities. This method is described in paragraphs 260-10-45-59A through 45-70. Diluted EPS would be computed in a similar manner. This Example has the following assumptions for the year 20X0:

a. Net income was $65,000.
b. 10,000 shares of $50 par value common stock were outstanding.
c. 5,000 shares of $100 par value nonconvertible preferred stock were outstanding.
d. The preferred stock was entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock.
e. After common stock has been paid a dividend of $2 per share, the preferred stock then participates in any additional dividends on a 40:60 per-share ratio with common stock. (That is, after preferred and common stock have been paid dividends of $5 and $2 per share, respectively, preferred stock participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)
f. Preferred stockholders have been paid $27,000 ($5.40 per share).
g. Common stockholders have been paid $26,000 ($2.60 per share).

55-63 Basic EPS for 20X0 would be computed as follows.

Net income		$ 65,000
Less dividends paid:		
Preferred	$ 27,000	
Common	26,000	53,000
Undistributed 20X0 earnings		$ 12,000

Allocation of undistributed earnings:

To preferred:

0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $3,000

$3,000 ÷ 5,000 shares = $0.60 per share

To common:

0.6(10,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $9,000

$9,000 ÷ 10,000 shares = $0.90 per share

Basic per-share amounts:

	Preferred Stock	**Common Stock**
Distributed earnings	$ 5.40	$ 2.60
Undistributed earnings	0.60	0.90
Totals	$ 6.00	$ 3.50

5.8 Examples of diluted EPS using the two-class method

The following examples were included in a 2008 exposure draft of a proposed amendment to FASB Statement No. 128 (earnings per share). While the proposal was never issued in final form, these examples are helpful in understanding how to calculate diluted EPS when applying the two-class method.

Excerpt from Exposure Draft: Earnings per Share

Illustration 6 – Basic EPS under the Two-Class Method

The two-class method of computing basic EPS is illustrated in the following example. This method is described in paragraph 61. The facts assumed for the year 20X0 are as follows:

- Net income was $65,000.
- 10,000 shares of $50 par value common stock were outstanding.
- 5,000 shares of $100 par value nonconvertible preferred stock were outstanding.
- The preferred stock was entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock.
- After common stock has been paid a dividend of $2 per share, the preferred stock then participates in any additional dividends on a 40:60 *per-share* ratio with common stock. (That is, after preferred and common stock have been paid dividends of $5 and $2 per share, respectively, preferred stock participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)
- Preferred stockholders have been paid $27,000 ($5.40 per share).
- Common stockholders have been paid $26,000 ($2.60 per share).

Basic EPS for 20X0 would be computed as follows:

Net income		$ 65,000
Less dividends paid:		
Preferred	$ 27,000	
Common	26,000	(53,000)
Undistributed 20X0 earnings		$ 12,000

Allocation of undistributed earnings:

To preferred:

0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $3,000

$3,000 ÷ 5,000 shares = $0.60 per share

To common:

0.6(10,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $9,000

$9,000 ÷ 10,000 shares = $0.90 per share

Basic per-share amounts:

	Preferred Stock	Common Stock
Distributed earnings	$ 5.40	$ 2.60

Undistributed earnings	0.60	0.90
Totals	$ 6.00	$ 3.50

Illustration 6A – Diluted EPS under the Two-Class Method

The two-class method for computing diluted EPS is illustrated in the following three scenarios. The method to compute diluted EPS under the two-class method is described in paragraph 61A of this Statement. The facts assumed for the year 20X1 are as follows:

Scenario 1—Common Stock with Participating Preferred Security

- Net income was $65,000.
- 10,000 shares of common stock were outstanding.
- 5,000 shares of nonconvertible preferred stock were outstanding.
- The preferred stock is entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock.
- After the common stock has been paid a dividend of $2 per share, the preferred stock participates in any additional dividends on a 40:60 per-share ratio with common stock. (That is, after the preferred and the common stock have been paid dividends of $5 and $2 per share, respectively, the preferred stock participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)
- Preferred stockholders have been paid $27,000 ($5.40 per share).
- Common shareholders have been paid $26,000 ($2.60 per share).
- On January 1, 20X1, the company issued the following instruments. These instruments are not measured at fair value each period with changes in fair value recognized in earnings.
  - 1,000 30-year convertible bonds with an aggregate par value of $1,000,000. Each bond is convertible into 8 shares of common stock and carries a coupon rate of 3 percent.
  - Options to employees to purchase 2,000 shares of common stock at $50 per share. The end-of-period market price of the company's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff vesting). The company expects all of the option awards to vest.
- The tax rate was 40 percent for 20X1.

Basic EPS for 20X1 under the Two-Class Method

Net income		$ 65,000
Less dividends paid:		
Preferred	$ 27,000	
Common	26,000	
		53,000
Undistributed 20X1 earnings		$ 12,000

Allocation of undistributed earnings:

To preferred:

0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $3,000

$3,000 ÷ 5,000 shares = $0.60 per share

To common:

0.6(10,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $9,000

$9,000 ÷ 10,000 shares = $0.90 per share

Basic per-share amounts:

	Preferred Stock	Common Stock
Distributed earnings	$ 5.40	$ 2.60
Undistributed earnings	0.60	0.90
Totals	$ 6.00	$ 3.50

Diluted EPS for 20X1 under the Two-Class Method

Antidilution Sequencing

	Increase in Earnings Available to Common Shareholders	Increase in Number of Common Shares	Earnings per Incremental Share
Options	–	142[a]	–
Convertible bonds	$ 18,000[b]	8,000[b]	$ 2.25

Calculation of Diluted EPS Assuming the Use of the Two-Class Method

	Undistributed and Distributed Earnings to Common Shareholders	Common Shares	Earnings per Share
As reported—basic	$ 35,000[c]	10,000	$ 3.50
Add-back: Undistributed earnings allocated to preferred shares	3,000	–	
Options	–	142[a]	
Less: Undistributed earnings reallocated to preferred shares	(2,968)[d]	–	
Subtotal	35,032	10,142	3.45
Add-back: Undistributed earnings allocated to preferred shares	2,968	–	
Convertible bonds	18,000[b]	8,000[b]	
Less: Undistributed earnings reallocated to preferred shares	(4,657)[e]	–	
Diluted EPS for common stock	**$ 51,343**	**18,142**	**$ 2.83**

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Exercise price	$50 × 2,000 = $100,000
End-of-period unrecognized compensation cost	{[($5 × 2,000) ÷ 4-year service period] × 3 remaining years of service} = $7,500
Excess tax benefit	{[($60 – $50) – $5] × 2,000} × 40% = $4,000
Shares repurchased	$111,500 ÷ $60 = 1,858
Incremental shares	2,000 – 1,858 = 142 shares

(b) Assumed conversion of the convertible bonds would result in 8,000 incremental shares and the add-back of $18,000 ([$1,000,000 × 3% × (1 – .4)] = $18,000) in after-tax interest expense to undistributed earnings for the period.

(c) Amount represents the aggregate of the distributed ($26,000) and undistributed earnings ($9,000) allocated to the common shareholders.

(d) Reallocation of undistributed earnings = 0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000 + 142)] × $12,000 undistributed earnings = $2,968

(e) 0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000 + 142 + 8,000)] × ($12,000 undistributed earnings + $18,000 interest add-back) = $4,657

Scenario 2—Two Classes of Common Stock with Different Dividend Rights; One Class Convertible into the Other

- Net income was $65,000.
- 10,000 shares of Class A common stock were outstanding.
- 10,000 shares of Class B common stock were outstanding.
- Each share of Class B common stock is convertible into one share of Class A common stock.
- Class B shareholders receive 95 percent of any dividends declared on Class A common stock on a per-share basis.
- Class A shareholders have been paid $10,000 ($1.00 per share).
- Class B shareholders have been paid $9,500 ($0.95 per share).
- On January 1, 20X1, the company granted options to employees to purchase 2,000 shares of Class A common stock at $50 per share. The options are not measured at fair value each period with changes in fair value recognized in earnings. The end-of-period market price of the company's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff vesting). The company expects all of the option awards to vest.
- The tax rate was 40 percent for 20X1.

Basic EPS for 20X1 under the Two-Class Method

Net income		$ 65,000
Less dividends paid:		
Class A	$ 10,000	
Class B	9,500	19,500
Undistributed 20X1 earnings		$ 45,500

Allocation of undistributed earnings:

To Class A:

1.0(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $23,333

$23,333 ÷ 10,000 shares = $2.33 per share

To Class B:

0.95(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $22,167

$22,167 ÷ 10,000 shares = $2.22 per share

Basic EPS amounts:

	Class A	**Class B**
Distributed earnings	$ 1.00	$ 0.95
Undistributed earnings	2.33	2.22
Total	$ 3.33	$ 3.17

Diluted EPS for 20X1 under the Two-Class Method for Class A Shares

Antidilution Sequencing

	Increase in Earnings Available to Class A Common Shareholders	Increase in Number of Class A Common Shares	Earnings per Incremental Share
Options	–	142[a]	–
Class B conversion	$ 31,667[b]	10,000	$ 3.17

Calculation of Diluted EPS for Class A Assuming the Use of the Two-Class Method and That Class B Does Not Convert

	Undistributed and Distributed Earnings to Class A Common Shareholders	Class A Common Shares	Earnings per Share
As reported—basic	$ 33,333[c]	10,000	$ 3.33
Add-back: Undistributed earnings allocated to Class B shares	22,167	–	
Options	–	142[a]	
Less: Undistributed earnings reallocated to Class B shares	(22,006)[d]	–	
Diluted EPS for Class A common stock	**$ 33,494**	**10,142**	**$ 3.30**

Calculation of Diluted EPS for Class A Assuming the Use of the If- Converted Method for Class B

	Undistributed and Distributed Earnings to Class A Common Shareholders	Class A Common Shares	Earnings per Share
As reported—basic	$ 33,333[c]	10,000	$ 3.33
Options	–	142[a]	
Subtotal	33,333	10,142	$ 3.29
Class B conversion	31,667[b]	10,000	
Diluted EPS for Class A common stock	**$ 65,000**	**20,142**	**$ 3.23**

Diluted EPS for 20X1 under the Two-Class Method for the Class B Shares

	Undistributed and Distributed Earnings to Class B Common Shareholders	Class B Common Shares	Earnings per Share
As reported—basic	$ 31,667[b]	10,000	$ 3.17
Less: Undistributed earnings allocated to Class B shares	(22,167)		

Add-back: Undistributed earnings reallocated to Class B shares	22,006[d]	–	
Diluted EPS for Class B common stock	**$ 31,506**	**10,000**	**$ 3.15**

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:

Exercise price	$50 × 2,000 = $100,000
End-of-period unrecognized compensation cost	{[($5 × 2,000) ÷ 4-year service period] × 3 remaining years of service} = $7,500
Excess tax benefit	{[($60 – $50) – $5] × 2,000} × 40% = $4,000
Shares repurchased	$111,500 ÷ $60 = 1,858
Incremental Class A shares	2,000 – 1,858 = 142 shares

(b) Amount represents the aggregate of the distributed ($9,500) and undistributed earnings ($22,167) allocated to the Class B common shareholders in the basic EPS computation.

(c) Amount represents the aggregate of the distributed ($10,000) and undistributed earnings ($23,333) allocated to the Class A common shareholders.

(d) Reallocation of undistributed earnings = 0.95(10,000) ÷ [1.0(10,000 + 142) + 0.95(10,000)] × $45,500 total undistributed earnings = $22,006

Note: In this scenario, the company would disclose diluted EPS per Class A shares using the if-converted method ($3.23) because that amount is more dilutive than the result yielded from the two-class method ($3.30). The company also would disclose the fact that diluted earnings per Class A shares assumes conversion of Class B shares into Class A shares because the effect is dilutive. Diluted earnings per Class B shares would be disclosed as $3.15, as determined by the two-class method above.

Scenario 3—Two Classes of Common Stock with Different Dividend Rights; One Class Convertible into the Other and Convertible Bonds Outstanding

- Net income was $65,000.
- 10,000 shares of Class A common stock were outstanding.
- 10,000 shares of Class B common stock were outstanding.
- Each share of Class B common stock is convertible into one share of Class A common stock.
- Class B shareholders receive 95 percent of any dividends declared on Class A common stock on a per-share basis.
- Class A shareholders have been paid $10,000 ($1.00 per share).
- Class B shareholders have been paid $9,500 ($0.95 per share).
- On January 1, 20X1, the company issued the following instruments. These instruments are not measured at fair value each period with changes in fair value recognized in earnings.
  - Options to employees to purchase 2,000 shares of Class A common stock at $50 per share. The end-of-period market price of the company's common stock for the year was $60 per share. The options have a grant- date fair value of $5 and a service period of 4 years (cliff vesting). The company expects all of the option awards to vest.
  - 500 30-year convertible bonds with an aggregate par value of $500,000. Each bond is convertible into 20 shares of Class A common stock (10,000 shares in total) and carries a coupon rate of 3 percent.
- The tax rate was 40 percent for 20X1.

Basic EPS for 20X1 under the Two-Class Method

Net income		$ 65,000
Less dividends paid:		
Class A	$ 10,000	
Class B	9,500	19,500
Undistributed 20X1 earnings		$ 45,500

Allocation of undistributed earnings:

To Class A:

1.0(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $23,333

$23,333 ÷ 10,000 shares = $2.33 per share

To Class B:

0.95(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $22,167

$22,167 ÷ 10,000 shares = $2.22 per share

Basic EPS amounts:

	Class A	**Class B**
Distributed earnings	$ 1.00	$ 0.95
Undistributed earnings	2.33	2.22
Total	$ 3.33	$ 3.17

Diluted EPS for 20X1 under the Two-Class Method for Class A Shares

Antidilution Sequencing

	Increase in Earnings Available to Class A Common Shareholders	**Increase in Number of Class A Common Shares**	**Earnings per Incremental Share**
Options	–	142[a]	–
Convertible bonds	$ 9,000[b]	10,000[b]	$ 0.90
Class B conversion	$ 31,667[c]	10,000	$ 3.17

Diluted EPS for 20X1 under the Two-Class Method for the Class B Shares

	Undistributed and Distributed Earnings to Class A Common Shareholders	**Class A Common Shares**	**Earnings per Share**
As reported—basic	$ 33,333[d]	10,000	$ 3.33
Add-back: Undistributed earnings allocated to Class B shares	22,167	–	
Options	–	142[a]	
Less: Undistributed earnings reallocated to Class B shares	(22,006)[e]	–	
Subtotal	33,494	10,142	$ 3.30

Add-back: Undistributed earnings allocated to Class B shares	22,006	–	
Convertible bonds	9,000[b]	10,000[b]	
Less: Undistributed earnings reallocated to Class B shares	(17,467)[f]	–	
Diluted EPS for Class A common stock	**$ 47,033**	**20,142**	**$ 2.34**

Calculation of Diluted EPS for Class A Assuming the Use of the If-Converted Method for Class B

	Undistributed and Distributed Earnings to Class A Common Shareholders	Class A Common Shares	Earnings per Share
As reported—basic	$ 33,333[d]	10,000	$ 3.33
Options	–	142[a]	
Subtotal	33,333	10,142	$ 3.29
Convertible bonds	9,000[b]	10,000[b]	
	42,333	20,142	$ 2.10
Class B conversion	31,667[c]	10,000	
Diluted EPS for Class A common stock	**$ 74,000**	**30,142**	**$ 2.46**

Diluted EPS for 20X1 under the Two-Class Method for the Class B Shares

	Undistributed and Distributed Earnings to Class B Common Shareholders	Class B Common Shares	Earnings per Share
As reported—basic	$ 31,667[c]	10,000	$ 3.17
Less: Undistributed earnings allocated to Class B shares	(22,167)	–	
Add-back: Undistributed earnings reallocated to Class B shares	17,467[f]		
Diluted EPS for Class B common stock	**$ 29,967**	**10,000**	**$ 2.70**

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:

Exercise price	$50 × 2,000 = $100,000
End-of-period unrecognized compensation cost	{[($5 × 2,000) ÷ 4-year service period] × 3 remaining years of service} = $7,500
Excess tax benefit	{[($60 – $50) – $5] × 2,000} × 40% = $4,000
Shares repurchased	$111,500 ÷ $60 = 1,858
Incremental shares	2,000 – 1,858 = 142 shares

(b) Assumed conversion of the convertible bonds would result in 10,000 incremental shares and the add-back of $9,000 [$500,000 × 3% × (1 – 0.4)] in after-tax interest expense to undistributed earnings for the period.

(c) Amount represents the aggregate of the distributed ($9,500) and undistributed earnings ($22,167) allocated to the Class B common shareholders in the basic EPS computation.

(d) Amount represents the aggregate of the distributed ($10,000) and undistributed earnings ($23,333) allocated to the Class A common shareholders.

(e) Reallocation of undistributed earnings = 0.95(10,000) ÷ [1.0(10,000 + 142) + 0.95(10,000)] × $45,500 undistributed earnings = $22,006

(f) Reallocation of undistributed earnings = 0.95(10,000) ÷ [1.0(10,000 + 142 + 10,000) + 0.95(10,000)] × ($45,500 undistributed earnings + $9,000 interest add-back) = $17,467

Note: In this scenario, the company would disclose diluted EPS per Class A shares using the two-class method ($2.34) because the assumed conversion of Class B shares using the if-converted method ($2.46) is less dilutive than the result yielded from the two-class method. Diluted earnings per Class B shares would be disclosed as $2.70, as determined by the two-class method above.

6. Consideration of specific instruments

Detailed contents

New item added to this edition: **
Item significantly updated in this edition: #

6.9 Options, warrants and forward sale contracts

Questions

Examples

Questions

Examples

Questions

6.19 Employee stock ownership plans

Questions

6.1 How the standard works

This section builds on the basic principles introduced in chapters 3 and 4, and explains the basic and diluted EPS implications of the following types of instruments.

Section	Instruments
6.2	Common shares issued in full for cash
6.3	Partially paid common shares
6.4	Stock dividends, splits and rights issues
6.5	Common shares issued to settle liabilities
6.6	Common shares issued to acquire assets
6.7	Common shares issued to acquire a business
6.8	Unvested common shares (including restricted stock)
6.9	Options, warrants and their equivalents[1]
6.10	Contingently issuable common shares (and common shares subject to recall)
6.11	Contingently issuable potential common shares
6.12	Convertible instruments[1]
6.13	Contracts that may be settled in shares or in cash[1]
6.14	Preferred shares
6.15	Written put options and forwards
6.16	Purchased puts and calls
6.17	Instruments over shares in, or issued by, a subsidiary, joint venture or equity method investee
6.18	Equity-classified instruments with a down-round feature[1]
6.19	Employee stock ownership plans
6.20	Employee stock purchase plans
6.21	EPS for instruments in SPAC transactions

Note:

1. Appendix A includes sections 6.9A, 6.12A, 6.13A and 6.18A, which present guidance for an entity that has not adopted ASUs 2020-06. The sections are structured similarly to sections 6.9, 6.12, 6.13 and 6.18, respectively, and the question and example numbers are the same, although not every question or example appears in both sections.

The EPS implications of the following types of instruments are explained in other parts of this Handbook.

Section	Instruments
5.2	Participating equity instruments and other classes of common shares
3.4.30	Treasury shares

Generally, each section provides a comprehensive treatment of the EPS calculations relevant to a particular type of instrument. However, an instrument may contain multiple features that are the subject of different sections. For example, some stock options may be settleable in cash, and therefore both section 6.9 (which covers stock options in general) and section 6.13 (which covers instruments with settlement options) are relevant. In these cases, cross-references between the relevant sections are provided.

Each section in this chapter is organized as follows.

<table>
<tr><th>Element</th><th colspan="2">What it does</th></tr>
<tr><td>Overview of the instrument</td><td colspan="2">Outlines the general characteristics of the instrument and defines the section’s scope. Although it also gives an overview of the accounting considerations that affect the EPS calculations for that instrument, it does not provide a comprehensive analysis of the accounting requirements in other Topics.</td></tr>
<tr><td rowspan="4">EPS implications</td><td colspan="2">Outlines the potential EPS implications of the instrument, split into basic EPS and diluted EPS. Symbols highlight whether the instrument may affect the numerator, the denominator or both.</td></tr>
<tr><td>Numerator X
Denominator X</td><td>The instrument does not affect that measure of EPS.</td></tr>
<tr><td>Numerator ✓
Denominator ✓</td><td>The instrument affects that measure of EPS.
— For basic EPS, this means the instrument may affect the calculation before common shares are actually issued.
— For diluted EPS, this means the instrument is taken into account, although whether adjustments are actually required depends on whether the instrument is dilutive.</td></tr>
<tr><td>Numerator X / ✓
Denominator X / ✓</td><td>Whether the instrument affects that measure of EPS will depend on the specific facts, as explained further.</td></tr>
<tr><td>Dilutive or anti-dilutive?</td><td colspan="2">Outlines the general features that determine whether the instrument is dilutive or antidilutive for diluted EPS.</td></tr>
<tr><td>Interpretive analysis and examples</td><td colspan="2">Discusses the EPS implications of the instrument through Q&As and Examples.</td></tr>
</table>

6.2 Common shares issued in full for cash

6.2.10 Overview of the instrument

A common share is "an equity instrument that is subordinate to all other classes of equity instruments of the issuer" (see section 2.2.10). [260-10 Glossary]

For examples in which common shares are issued during the period, see sections 3.4 and 4.7.

6.2.20 EPS implications

Common shares issued in full for cash are included in the denominator for basic EPS.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / Denominator ✓	Numerator X / Denominator X
The weighted-average number of outstanding common shares for a period is the denominator in basic EPS. Common shares issued in full for cash consideration are included in the weighted-average number of outstanding common shares from the date on which the shares are issued (see sections 3.4.20 and 6.3).	Common shares are not potential common shares. Therefore, there are no additional diluted EPS implications.

Question 6.2.10#

Are shares issued in an IPO or any other offering included in basic EPS from the trade date or the settlement date?

Interpretive response: We believe that when an entity issues shares in an IPO or any other offering, these shares are considered outstanding for EPS purposes from the settlement date. However, because these shares are generally entitled to dividends from the trade date, we believe they are considered a participating security from trade date until settlement date (see chapter 5).

6.3 Partially paid common shares

Excerpt from ASC 260-10

• > Partially Paid Shares and Partially Paid Stock Subscriptions

55-23 If an entity has common shares issued in a partially paid form (permitted in some countries) and those shares are entitled to dividends in proportion to the amount paid, the common-share equivalent of those partially paid shares shall be included in the computation of basic EPS to the extent that they were entitled to participate in dividends. Partially paid stock subscriptions that do not share in dividends until fully paid are considered the equivalent of warrants and shall be included in diluted EPS by use of the treasury stock method. That is, the unpaid balance shall be assumed to be proceeds used to purchase stock under the treasury stock method. The number of shares included in diluted EPS shall be the difference between the number of shares subscribed and the number of shares assumed to be purchased.

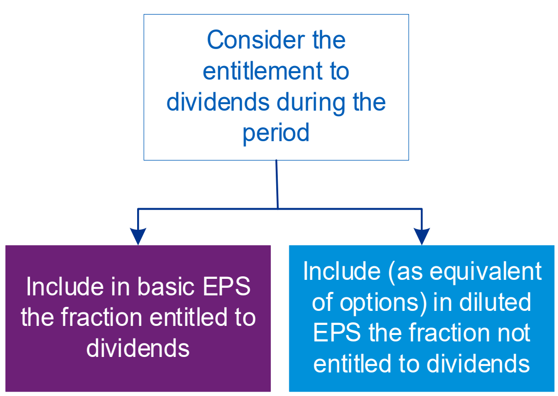
6.3.10 Overview of the instrument

This section discusses common shares that are only partly paid in cash at issuance, with the balance of the subscription price required to be paid only as and when it is called for by the issuing entity. Applicable governing documents will determine the following:

— the rights of the holders of such shares to dividends;
— the winding-up or liquidation of the entity; and
— the rights of the entity if the balance is not paid when required.

6.3.20 EPS implications

Generally, how partially paid common shares affect EPS calculations depends on their dividend participation relative to fully paid common shares. This may not be the same as the percentage of the subscription price paid.



Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator ✓	Numerator X Denominator ✓
To the extent that a partially paid common share is entitled to participate in dividends during the period relative to a fully paid common share, it is treated as a fraction of a common share in the denominator. [260-10-55-23]	To the extent that a partially paid common share is not entitled to participate in dividends during the period, it is treated as the equivalent of an option or warrant (see section 6.9). [260-10-55-23] No adjustment is necessary in the numerator because the payment of the remaining balance has no consequential effect on earnings. The potential adjustment to the denominator is determined by applying the treasury stock method (see section 6.9.30) to the fraction of partially paid common shares that is not entitled to participate in dividends. The unpaid balance is assumed to be the proceeds used to hypothetically purchase common shares at the average market price for the period; or the period for which the partially paid common shares are outstanding, if this is shorter. The potential adjustment to the denominator is the number of incremental shares that are assumed to be issued and is the difference between: [260-10-55-23] — the number of shares subscribed; and — the number of common shares assumed to be purchased at the average market price with the unpaid balance.
Dilutive or antidilutive? It depends. Generally, partially paid common shares are dilutive when the unpaid balance per share is lower than the average market price of a common share during the period.	

Observation
Unpaid stock subscriptions

Careful consideration of the unpaid portion of a stock subscription is made to determine whether it has a right to participate in dividends. If the unpaid portion of the subscription (or wholly unpaid subscription) is entitled to participate in dividends, the subscription is treated as an option that is a participating security. The more dilutive of the treasury stock or two-class method is used to calculate diluted EPS.

6.3.30 Interpretive analysis and examples

Example 6.3.10
Partially paid common shares with participation rights

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On April 1, Year 1, it issues 1,000,000 additional common shares. Each share has a $10 subscription price, payable under the following schedule:

— 80% of the issue price is due at issue (April 1, Year 1)
— 20% of the issue price is due when called for by ABC.

Therefore, ABC receives $8 per share on April 1, Year 1. It does not call the remaining 20% during Year 1.

Under the applicable laws and ABC's corporate documents, holders of the partially paid common shares are entitled to participate in dividends at the percentage of shares that are paid up, as compared with fully paid common shares.

The average market price of ABC's common shares between April 1 and December 31, Year 1 is $12. Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,600,000	3,625,000
EPS	$1.28	$1.27

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

Partially paid common shares are treated as fractions of common shares to the extent of their dividend rights. Therefore, each of the 1,000,000 partially paid common shares is treated as 80% of a common share when determining the denominator (i.e. 800,000 shares). ABC calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Jan. – Mar.	3,000,000	3/12	750,000
Apr. 1: partially paid common shares issued	800,000		
Apr. – Dec.	3,800,000	9/12	2,850,000
		12/12	
Weighted average for the year			**3,600,000**

Therefore, the denominator is 3,600,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,600,000 = $1.28.

Diluted EPS

1 Identify potential common shares

The partially paid common shares are potential common shares from April 1, Year 1, because they are treated as the equivalent of warrants or options to the extent that they are not entitled to dividends relative to fully paid common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required.

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9), as follows.

Step i	Fraction of partly paid common shares not entitled to dividends (1 – 80%) × 1,000,000	200,000	(A)
	Subscription price	$10	(B)
	Assumed proceeds	**$2,000,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$12	(D)
	Number of common shares deemed repurchased	**166,667**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**33,333**	(F) = (A) – (E)

The number of incremental shares is weighted for the period the common shares are not fully paid (April 1 to December 31): 33,333 × 9/12 = 25,000.

3 Rank the potential common shares

This step does not apply, because there is only one class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.28 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The partially paid common shares are dilutive because no adjustment to the numerator for EPIS is required and the unpaid balance per share is lower than the average market price of a common share during the period.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,600,000	$1.28	
Partially paid common shares issued on April 1	-	25,000		
Total	**$4,600,000**	**3,625,000**	$1.27	✓

Therefore, ABC includes the effect of the partially paid common shares in diluted EPS.

Diluted EPS = $1.27

6.4 Stock dividends, splits and rights issues

Excerpt from ASC 260-10

• • > Stock Dividends or Stock Splits

55-12 If the number of common shares outstanding increases as a result of a **stock dividend** or stock split (see Subtopic 505-20) or decreases as a result of a reverse stock split, the computations of basic and diluted EPS shall be adjusted retroactively for all periods presented to reflect that change in capital structure. If changes in common stock resulting from stock dividends, stock splits, or reverse stock splits occur after the close of the period but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the per-share computations for those and any prior-period financial statements presented shall be based on the new number of shares. If per-share computations reflect such changes in the number of shares, that fact shall be disclosed.

• • > Rights Issues

55-13 A **rights issue** whose exercise price at issuance is less than the fair value of the stock contains a bonus element that is somewhat similar to a stock dividend. If a rights issue contains a bonus element and the rights issue is offered to all existing stockholders, basic and diluted EPS shall be adjusted retroactively for the bonus element for all periods presented. If the ability to exercise the rights issue is contingent on some event other than the passage of time, the provisions of this paragraph shall not be applicable until that contingency is resolved.

55-14 The number of common shares used in computing basic and diluted EPS for all periods prior to the rights issue shall be the number of common shares outstanding immediately prior to the issue multiplied by the following factor: (fair value per share immediately prior to the exercise of the rights)/(theoretical ex-rights fair value per share). Theoretical ex-rights fair value per share shall be computed by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds expected from the exercise of the rights and dividing by the number of shares outstanding after the exercise of the rights. Example 5 (see paragraph 260-10-55-60) illustrates that provision. If the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this computation shall be established at the close of the last day on which the shares are traded together with the rights.

6.4.10 Overview of the instrument

Stock dividends are dividends paid to an entity's common shareholders in the form of additional common shares instead of in cash. They may also be referred to as 'scrip', or 'share dividends', and they may or may not have a cash alternative.

A rights issue is an offer to existing shareholders to purchase additional common shares in accordance with an agreement for a specified amount (generally substantially less than the fair value of the shares) for a given period. An offer that is not made to all shareholders but is instead a negotiated transaction with a counterparty that includes a discount, is not considered a rights offering. [260-10 Glossary, 260-10-55-13]

6.4.20 EPS implications

Generally, how stock dividends affect EPS depends on whether the investor has a cash alternative.

In a rights issue in which the exercise price is less than the fair value of the common shares, the inherent discount is similar to a stock dividend. However, unlike a stock dividend, the bonus element inherent in a rights issue is measured by a prescribed formula that is specified in Topic 260. Section 7.4 discusses rights issues in depth. [260-10-55-13 – 55-14]

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator ✓	Numerator X Denominator X
Topic 260 requires retrospective adjustment to the weighted-average number of shares outstanding in the case of a stock dividend. However, not all dividends received in shares are considered stock dividends (see section 7.3.10). [260-10-55-12, 505-20-15-3 – 15-3A] The treatment of stock dividends in the EPS calculation depends on whether the shareholders have an option to receive cash and whether there is an inherent bonus element. — If shareholders have an option to receive either a cash dividend or a stock dividend of equal value, the entity essentially exchanges shares for an equal amount of cash savings. This is treated as a contract that may be settled in shares or in cash (see section 6.13). [505-20-15-3A] — If the stock dividends do not have any cash alternative, their substance is that of a bonus issue that increases the number of shares outstanding without a corresponding change in resources. In this case, the additional shares issued as stock dividends are treated as if they had been issued since the beginning of the earliest period presented, necessitating a retrospective adjustment to EPS (see section 7.2). [260-10-55-13] The bonus element in a rights issue is calculated according to a formula specified in Topic 260, and the share equivalent is added to the denominator as of the beginning of the earliest period presented (see section 7.4.20). [260-10-55-13 – 55-14]	Common shares issued as stock dividends are not potential common shares. Therefore, there are no additional diluted EPS implications.

6.4.30 Interpretive analysis and examples

Question 6.4.10

How is EPS affected by stock dividends with a bonus element?

Interpretive response: A bonus element in a stock dividend requires retrospective adjustments to EPS amounts. Under some dividend reinvestment programs, the fair value of the stock alternative exceeds that of the cash alternative (often referred to as 'enhanced' stock dividends).

In this case, we believe there is a bonus element to the stock alternative. Further, we believe the bonus element in stock dividends should be determined using the same formula as for determining a bonus element in a rights issue (see section 7.4.30). [260-10-55-13]

Example 6.4.10

Stock dividends with cash alternative – without bonus element

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On April 1, Year 1, it declares a dividend whereby ABC's common shareholders have the option to receive either:

— cash of $2 per share; or
— additional common shares of ABC up to the value of the cash alternative, based on the market price of ABC's shares on May 1, Year 1.

On May 1, Year 1, 60% of the common shareholders opt for the stock alternative when the market price of ABC's common shares is $5 per share. Therefore, 720,000 common shares are issued as stock dividends: (3,000,000 × 60%) × (2 ÷ 5).

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,480,000	3,480,000
EPS	$1.32	$1.32

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

Because the stock alternative and the cash alternative are of equal value, we believe the 720,000 shares issued on May 1 increase the number of shares with a corresponding change in resources and do not have any bonus element.

Therefore, ABC includes 720,000 shares in the denominator prospectively from the date on which the dividends are reinvested and does not restate prior-period EPS amounts (see Question 7.3.20).

	Number of shares	Time weighting	Weighted average
Jan. – Apr.	3,000,000	4/12	1,000,000
May 1: stock dividends	720,000		
May – Dec.	3,720,000	8/12	2,480,000
		12/12	
Weighted average for the year			**3,480,000**

Therefore, the denominator is 3,480,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,480,000 = $1.32

Diluted EPS

1 Identify potential common shares

The shares issued as stock dividends are not potential common shares. Therefore, Steps 2 to 4 do not apply.

2 For each potential common share, calculate EPIS

Not applicable.

3 Rank the potential common shares

Not applicable.

4 Determine basic EPS from continuing operations

Not applicable.

5 Identify dilutive potential common shares and determine diluted EPS

Because there are no potential common shares, diluted EPS is the same as basic EPS.

Diluted EPS = $1.32

Example 6.4.20

Stock dividends with cash alternative – with bonus element

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

- On April 1, Year 1, ABC declares a dividend whereby its common shareholders have the option to receive either:
  - cash of $2 per share; or
  - additional ABC common shares up to the value of the cash alternative, based on a 25% discount on the market price of ABC's common shares on May 1, Year 1.
- On May 1, Year 1, 60% of the common shareholders opt for the stock alternative when the market price of ABC's common shares is $5 per share. Therefore, 960,000 common shares are issued as stock dividends: 3,000,000 × 60% × 2 ÷ (5 × (1 – 25%)).

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,705,000	3,705,000
EPS	$1.24	$1.24

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

Because the value of the stock alternative exceeds that of the cash alternative, part of the shares issued as stock dividends was for no consideration. This represents the bonus element and is calculated as follows (see section 7.3).

Number of shares outstanding before issuance of stock dividends	3,000,000	(A)
Number of shares issued	960,000	(B)
Amount of cash given up by shareholder on issuance of shares (3,000,000 × 60% × 2)	$3,600,000	(C)
Fair value per share immediately before issuance	**$5**	(D)
Aggregate fair value of shares immediately before issuance of stock dividends	$15,000,000	(E) = (A) × (D)
Proceeds from issuance of stock dividends	$3,600,000	(C)
Number of shares outstanding after issuance of stock dividend	3,960,000	(F) = (A) + (B)
Theoretical ex-rights fair value per share	**$4.697**	(G) = ((E) + (C)) ÷ (F)
Bonus factor	**1.065**	(D) ÷ (G)

Therefore, the adjustment factor for the bonus element in the stock dividends is multiplied by the outstanding shares before the May 1 stock dividend to determine the retrospective adjustment.

	Number of shares	Time weighting	Weighted average
Outstanding shares as of Jan. 1	3,000,000		
Bonus element in stock dividends [(3,000,000 × 1.065) – 3,000,000]	195,000		
Jan. – Apr.	3,195,000	4/12	1,065,000
May 1: stock dividends less effect of bonus element [960,000 – 195,000]	765,000		
May – Dec.	3,960,000	8/12	2,640,000
		12/12	
Weighted average for the year			**3,705,000**

Therefore, the denominator is 3,705,000.

The bonus element also affects prior-period EPS amounts.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,705,000 = $1.24

Diluted EPS

1 Identify potential common shares

The shares issued as stock dividends are not potential common shares. Therefore, Steps 2 to 4 do not apply.

2 For each potential common share, calculate EPIS

Not applicable.

3 Rank the potential common shares

Not applicable.

4 Determine basic EPS from continuing operations

Not applicable.

5 Identify dilutive potential common shares and determine diluted EPS

Because there are no potential common shares, diluted EPS is the same as basic EPS.

Diluted EPS = $1.24

Example 5 in Topic 260 (reproduced below) also illustrates the EPS treatment of rights issues.

Excerpt from ASC 260-10

• > Example 5: Rights Issues

55-60 This Example illustrates the provisions for stock rights issues that contain a bonus element as described in paragraphs 260-10-55-13 through 55-14. This Example has the following assumptions:

a. Net income was $1,100 for the year ended December 31, 20X0.
b. 500 common shares were outstanding for the entire year ended December 31, 20X0.
c. A rights issue was offered to all existing shareholders in January 20X1. The last date to exercise the rights was March 1, 20X1. The offer provided 1 common share for each 5 outstanding common shares (100 new shares).
d. The exercise price for the rights issue was $5 per share acquired.
e. The fair value of 1 common share was $11 at March 1, 20X1.
f. Basic EPS for the year 20X0 (prior to the rights issuance) was $2.20.

55-61 As a result of the bonus element in the January 20X1 rights issue, basic and diluted EPS for 20X0 will have to be adjusted retroactively. The number of common shares used in computing basic and diluted EPS is the number of shares outstanding immediately prior to the rights issue (500) multiplied by an adjustment factor. Prior to computing the adjustment factor, the theoretical ex-rights fair value per share must be computed. Those computations follow.

Theoretical ex-rights fair value per share[(a)]	$10	=	$\frac{(500 \times \$11) + (100 \times \$5)}{(500 + 100)}$
Adjustment factor[(b)]	1.1	=	$11 ÷ $10
Denominator for restating basic EPS	550	=	500 × 1.1
Restated basic EPS for 20X0	$2.00	=	$1,100 ÷ 550

(a) The equation for computing the theoretical ex-rights fair value per share is:

$$\frac{\text{Aggregate fair value of shares prior to exercise of rights + Proceeds from exercise of rights}}{\text{Total shares outstanding after exercise of rights}}$$

(b) The equation for computing the adjustment factor is:

$$\frac{\text{Fair value per share immediately prior to exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

Diluted EPS would be adjusted retroactively by adding 50 shares to the denominator that was used in computing diluted EPS prior to the restatement.

6.5 Common shares issued to settle liabilities

6.5.10 Overview of the instrument

Topic 260 does not explicitly discuss common shares issued to fully or partially extinguish a financial or nonfinancial liability as a result of renegotiating the terms of the liabilities. However, this section applies the principles of Topic 260 to those types of shares.

This section does not address:

- the issuance of common shares to settle financial liabilities that have an option of conversion to shares. For further discussion of such shares, see:
  - options, warrants and their equivalents, section 6.9;
  - written put options and forwards, section 6.15;
  - convertible instruments, section 6.12.
- the issuance of common shares subject to conditions other than the passage of time (see sections 6.8 and 6.10).

6.5.20 EPS implications

Generally, common shares issued to settle liabilities affect only basic EPS.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator ✓	Numerator X Denominator X
Generally, common shares issued are included in the denominator from the date on which the liability is extinguished. Therefore, we believe: — common shares issued in place of interest or principal on debt or other financial instruments are included in the denominator from the date on which the interest ceases to accrue; and — common shares issued in exchange for the settlement of a liability are included from the extinguishment date.	Common shares issued to settle liabilities are not potential common shares. Therefore, there are no additional diluted EPS implications.

6.5.30 Interpretive analysis and examples

Example 6.5.10
Common shares issued to settle liabilities

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

During the year, ABC issues additional shares to settle liabilities.

— On July 1, Year 1, it agrees with certain debt holders to issue 200,000 common shares in settlement of noninterest-bearing loans of $350,000 from these debt holders. The loans are settled and the shares are issued on this date.

— On October 1, Year 1, ABC agrees with third-party creditors to issue 250,000 common shares in settlement of interest-bearing loan notes of $450,000. Based on the terms of the agreement, the loan notes cease to bear interest from this date. The shares are issued on October 15, Year 1. Because the issuance of shares is only subject to the passage of time (see sections 6.8 and 6.10), the shares are included in basic EPS as of October 1.

The carrying amount of the liabilities settled on both dates equals the fair value of the shares issued.

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,162,500	3,162,500
EPS	$1.45	$1.45

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

The shares issued in settlement of the shareholders' loans are included in the denominator from the settlement date (July 1). In contrast, the shares issued in settlement of the third-party loan notes are treated as outstanding from the date on which interest ceases to accrue (October 1).

Therefore, ABC calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Jan. – Jun.	3,000,000	6/12	1,500,000
Jul. 1: shares issued to settle shareholders' loans	200,000		
Jul. – Sept.	3,200,000	3/12	800,000
Oct. 1: shares issued to settle loan notes	250,000		
Oct. – Dec.	3,450,000	3/12	862,500
		12/12	
Weighted average for the year			**3,162,500**

Therefore, the denominator is 3,162,500.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,162,500 = $1.45

Diluted EPS

1 Identify potential common shares

The shares issued to settle liabilities are not potential common shares. Therefore, Steps 2 to 4 do not apply.

2 For each potential common share, calculate EPIS

Not applicable.

3 Rank the potential common shares

Not applicable.

4 Determine basic EPS from continuing operations

Not applicable.

5 Identify dilutive potential common shares and determine diluted EPS

Because there are no potential common shares, diluted EPS is the same as basic EPS.

Diluted EPS = $1.45

6.6 Common shares issued to acquire assets

6.6.10 Overview of the instrument

This section discusses common shares issued to acquire an asset or a group of assets that does not constitute a business as defined in Topic 805 (business combinations). Generally, if an entity acquires goods or services to be used or consumed in the entity's own operations by issuing (or offering to issue) its own equity instruments, Topic 718 (stock compensation) applies. [718-10-15-3 – 15-4]

This section does not address:

— the issuance of common shares to acquire a business (see section 6.7);

— the issuance of common shares subject to conditions other than the passage of time (see sections 6.8 and 6.10); and

— contingently issuable shares that are subject to conditions other than the passage of time and that may be included in the consideration in an asset acquisition (see section 6.10).

6.6.20 EPS implications

Generally, common shares issued to acquire assets affect only basic EPS.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / Denominator ✓	Numerator X / Denominator X
Generally, common shares issued or issuable for the acquisition of an asset other than cash are included in the denominator as of the date on which the acquisition is recognized, as long as their issuance is not subject to conditions other than the passage of time. This is irrespective of whether the common shares may be issued at a later date. [718-10-25-2]	Common shares issued or issuable to acquire assets are included in basic EPS if their issuance is not subject to conditions other than the passage of time. Therefore, they are not potential common shares and there are no additional diluted EPS implications. Common shares whose issuance is subject to conditions other than the passage of time are subject to the guidance on contingently issuable shares (see section 6.10).

6.6.30 Interpretive analysis and examples

Example 6.6.10
Common shares issued to acquire an asset

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

During the year, ABC issues additional shares through the following transactions.

— On May 1, Year 1, it acquires a building, which it recognizes as property, plant and equipment in its financial statements on that date. The consideration is to be satisfied by issuing 150,000 common shares.

— On May 31, Year 1, it issues 150,000 shares to settle the consideration payable. The fair value of the assets equals the fair value of the shares issued.

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,100,000	3,100,000
EPS	$1.48	$1.48

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

The shares issued to acquire the building are included in the denominator from the date on which the acquisition is recognized in the financial statements (May 1). Therefore, ABC calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Jan. – Apr.	3,000,000	4/12	1,000,000
May 1: shares issued to acquire building	150,000		
May – Dec.	3,150,000	8/12	2,100,000
		12/12	
Weighted average for the year			**3,100,000**

Therefore, the denominator is 3,100,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,100,000 = $1.48

Diluted EPS

1 Identify potential common shares

The shares issued for the acquisition of an asset are not potential common shares. Therefore, Steps 2 to 4 do not apply.

2 For each potential common share, calculate EPIS

Not applicable.

3 Rank the potential common shares

Not applicable.

4 Determine basic EPS from continuing operations

Not applicable.

5 Identify dilutive potential common shares and determine diluted EPS

Because there are no potential common shares, diluted EPS is the same as basic EPS.

Diluted EPS = $1.48

6.7 Common shares issued to acquire a business

Excerpt from ASC 260-10

• > Business Combinations and Reorganizations

55-17 When common shares are issued to acquire a business in a business combination, the computations of EPS shall recognize the existence of the new shares only from the acquisition date. In reorganizations, EPS computations shall be based on analysis of the particular transaction and the provisions of this Subtopic.

6.7.10 Overview of the instrument

This section discusses common shares issued by an acquirer in a business combination in exchange for control of an acquiree.

Share consideration in a business combination can be broadly classified into the following three categories:

— shares issued at the date of acquisition
— **deferred consideration** – shares that will be issued at a future date but whose issue is not subject to any conditions other than the passage of time
— **contingent consideration** – shares that may be issued (or returned) if specified future events occur or conditions are met.

An acquirer presents contingent consideration settleable in common shares as a liability or as equity under the applicable Codification Topic. For example, if the acquirer may be required to issue additional common shares to the value of a specified monetary amount, the contingent consideration is presented as a financial liability that is subsequently measured at fair value. [805-30-25-6, 35-1]

This section does not address the following.

— **Reverse acquisitions.** In some business combinations, the entity that issues shares to acquire the interest in another entity is identified as the acquiree for accounting purposes. Such business combinations (referred to as reverse acquisitions) present specific challenges in determining EPS amounts that are discussed in section 7.5.

— **Transactions between entities under common control.** Transactions between entities under common control, accounted for under the as-if pooling method, have specific EPS implications that are discussed in section 7.5.

— **Pro forma EPS presentation.** An entity that enters into a material business combination is required to present pro forma disclosure in the notes to the financial statements of what earnings would have been in the prior year and current year if the business combination had taken place at the beginning of each respective period, including EPS information. Pro forma EPS presentation is discussed in section 9.2.

6.7.20 EPS implications

Common shares described in the first two categories in section 6.7.10 issued to acquire a business affect only basic EPS. The third category (i.e. contingent consideration settleable in common shares) can affect diluted EPS, and is discussed in section 6.10.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator ✓	Numerator X Denominator X / ✓
With the exception of contingent consideration settleable in shares, common shares issued or issuable are generally included in the denominator from the date of acquisition, which is the date on which the acquirer obtains control of the acquiree. [260-10-55-17] This applies regardless of whether the common shares may be issued at a date later than the date of acquisition. Therefore, deferred consideration settleable in shares is included in the denominator from the date of acquisition, and not from the date on which the shares are actually issued.	There is no effect on diluted EPS for the shares that are already included in basic EPS. Contingent consideration settleable in shares is included in diluted EPS in accordance with the guidance on contingently issuable shares (see section 6.10).

6.7.30 Contingent consideration

Shares that form part of contingent consideration are generally regarded as contingently issuable common shares, because they are typically issued for little or no further cash or other consideration on satisfying specified conditions. These shares are not considered outstanding and are not included in the denominator of basic EPS until all of the specified conditions (other than the passage of time) have been satisfied – i.e. until the date on which their issuance is no longer contingent. Before then, these shares are potential common shares that are taken into consideration when determining diluted EPS (see section 6.10). [260-10-45-13, 45-48]

6.7.40 Interpretive analysis and examples

Example 6.7.10
Common shares issued in a business combination – deferred consideration

Parent has 3,000,000 common shares outstanding on January 1, Year 1.

During the year, ABC issues additional shares through the following transactions.

- On May 1, Year 1, Parent agrees with the shareholders of Subsidiary to acquire 100% of Subsidiary for a combination of cash and share consideration. The acquisition qualifies as a business combination under Topic 805.
- On June 1, Year 1, Parent settles the cash consideration and acquires control over Subsidiary in accordance with the acquisition agreement. Parent settles the consideration by issuing:
  - 300,000 common shares on August 1, Year 1; and
  - another 100,000 shares (i.e. the remainder of the deferred consideration) on November 1.

The issuance of these shares is not subject to any conditions other than the passage of time.

Parent's net income for Year 1 is $4,600,000 (inclusive of Subsidiary's income from June 1 – December 31).

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,233,333	3,233,333
EPS	$1.42	$1.42

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

The shares issued to acquire Subsidiary are treated as outstanding in the denominator from the date of acquisition of June 1, although they are actually issued on August 1 and November 1. Therefore, Parent calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Jan. – May	3,000,000	5/12	1,250,000
Jun. 1: shares issued to acquire Subsidiary	400,000		
Jun. – Dec.	3,400,000	7/12	1,983,333
		12/12	
Weighted average for the year			**3,233,333**

Therefore, the denominator is 3,233,333.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,233,333 = $1.42

Diluted EPS

1 Identify potential common shares

The shares issued to acquire Subsidiary are not potential common shares. Therefore, Steps 2 to 4 do not apply.

2 For each potential common share, calculate EPIS

Not applicable.

3 Rank the potential common shares

Not applicable.

4 Determine basic EPS from continuing operations

Not applicable.

5 Identify dilutive potential common shares and determine diluted EPS

Because there are no potential common shares, diluted EPS is the same as basic EPS.

Diluted EPS = $1.42

Example 6.7.20

Common shares issued in a business combination – contingent consideration

The basic facts are the same as in Example 6.7.10, but instead of using deferred consideration to acquire Subsidiary, Parent uses contingent consideration. Under these modified facts, the consideration includes:

- cash consideration, which Parent pays on June 1, Year 1 when it acquires control over Subsidiary; and
- contingent consideration with the following terms:
  - 500,000 of Parent's common shares if Subsidiary's net income for a 12-month period ending at May 31, Year 2 is greater than $750,000; or
  - 600,000 of Parent's common shares if Subsidiary's net income for the same period is greater than $1,500,000.

Parent recognizes this contingent consideration as a financial liability.

Subsidiary's net income for the period from June 1 – December 31, Year 1 is $800,000. As a result, there is a $100,000 change in the fair value of the contingent consideration liability, which Parent recognizes as an expense in earnings in Year 1. This expense is tax deductible, and the applicable income tax rate is 21%.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,679,000
Denominator	3,000,000	3,291,667
EPS	$1.53	$1.42

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary before the end of the contingency period for the contingently issuable shares and the satisfaction of the conditions. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = \$4,600,000 ÷ 3,000,000 = \$1.53

Diluted EPS

1 Identify potential common shares

The contingently issuable common shares are potential common shares.

Although the cumulative earnings target is not tested until the end of the 12-month period, if the end of Year 1 were the end of the contingency period, the first target would be met. This is because Subsidiary's cumulative earnings up to the end of Year 1 are \$800,000, which exceeds \$750,000 but is less than \$1,500,000. Therefore, 500,000 shares are included in the denominator (see section 6.11).

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The contingently issuable shares, if they are issued, increase income or loss by the after-tax amount of the expense recognized for changes in the fair value of the liability:

> (expense for changes in fair value of liability) × (1 – income tax rate) = \$100,000 × (1 – 21%) = \$79,000

Potential adjustment to the denominator for EPIS: The weighted-average number of shares is included in the denominator from June 1:

> 500,000 × 7/12 = 291,667

EPIS is therefore \$79,000 ÷ 291,667 = \$0.27

3 Rank the potential common shares

This step does not apply, because the contingently issuable shares are the only potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is \$1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the contingently issuable common shares is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Effect of contingently issuable shares	79,000	291,667		
Total	**$4,679,000**	**3,291,667**	$1.42	✓

Therefore, Parent includes the contingently issuable shares in diluted EPS.

Diluted EPS = $1.42

Question 6.7.10

How should EPS be calculated in an IPO in connection with a spinoff or carve-out?

Interpretive response: If an IPO is conducted for a *carve-out* business (i.e. a business that previously existed as an unincorporated division of another entity), the number of shares issued on its formation or incorporation should generally be used in the denominator of basic EPS for historical periods (i.e. periods before formation) if EPS is presented for unincorporated periods. The formation date shares are treated similar to a stock split in that the parent entity owned 100% of the division in all prior periods and the form of ownership changes on incorporation without inflow or outflow of capital.

For an existing subsidiary (i.e. an entity contained in its own legal entity before the offering), the appropriate presentation depends on the situation. In many cases, the number of shares outstanding at the IPO date (excluding shares to be issued in the offering), should be used in historical EPS calculations if the entity was wholly owned during those periods. In other cases, the use of actual shares outstanding in prior periods may be most appropriate. New shares that are issued in the IPO are included prospectively in EPS calculations from the date issued. [260-10-45-10]

Question 6.7.20

When does an entity begin including shares issued to acquire an equity method investee in the denominator of basic EPS?

Interpretive response: An entity may issue common shares to acquire an equity method investment. Because these acquisitions are not business combinations, they are not specifically addressed by paragraph 260-10-55-17. Nevertheless, we believe the entity includes the shares in the denominator for basic EPS from the date it initially accounts for the equity method investment just as it does in accounting for the acquisition of other assets or asset groups (including the effect of contingently issuable shares) (see sections 6.6 and 6.10).

6.8 Unvested common shares (including restricted stock)

6.8.10 Overview of the instrument

Unvested shares are commonly granted in exchange for services from employees or nonemployees. Generally, if an entity receives goods or services as consideration for its own equity instruments, Topic 718 applies. Under that Topic, vesting conditions are either performance or service conditions. [718-10 Glossary]

— Service conditions require the counterparty to complete a specified period of service.

— Performance conditions require the counterparty to complete a specified period of service and to meet specified performance targets related to the entity's operations.

Market or other conditions are not considered vesting conditions but may affect the number of shares assumed to be outstanding for EPS purposes. [718-10 Glossary, 260-10-45-52, 45-54]

This section discusses unvested common shares whose vesting is conditional only on satisfying service conditions. Unvested shares subject to market or performance conditions are regarded as contingently issuable common shares for EPS purposes (see section 6.10).

This section does not address:

— shares that are issuable for little or no cash consideration (see section 6.10); and
— contracts that may be settled either in shares or in cash (see section 6.13).

Additional considerations in the context of share-based payment awards are discussed in section 6.9.50.

6.8.20 EPS implications

The EPS implications of common shares issued in exchange for services depend on when the common shares are granted and vested.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / ✓ Denominator X	Numerator X / ✓ Denominator ✓

Potential effect on basic EPS	Potential effect on diluted EPS
Unvested common shares are not regarded as outstanding until they are vested. [260-10-45-13] Common shares may be entitled to non-forfeitable dividends during the vesting period. If this is the case, to the extent these dividends have not been recognized in earnings, the numerator is adjusted for these dividends and any undistributed earnings attributable to these shares, in accordance with their participation rights (see section 5.3). This is because the numerator is intended to reflect amounts that are available to outstanding common shares. The unvested shares are not regarded as outstanding, but in this case are considered participating securities. [260-10-45-61A]	Unvested common shares are treated as options in diluted EPS. [260-10-45-22, 45-28A] Generally, no adjustment is necessary in the numerator because unvested common shares and shares subject to recall are classified as equity. However, to the extent these shares are entitled to dividends, adjustments to basic EPS (see analysis in basic EPS column) are added back to the numerator in diluted EPS. In this case, the potential adjustment to the denominator is determined using the more dilutive of the treasury stock method (see section 6.9) or the two-class method (see section 5.7). [260-10-45-22]
Dilutive or antidilutive? Because unvested common shares are treated as options in diluted EPS, they are generally dilutive if the average market price of common shares during the period exceeds the assumed proceeds (generally, the fair value of services to be supplied to the entity in the future). [260-10-45-25] However, to the extent these shares are entitled to dividends, the numerator may also be affected by the adjustments in basic EPS that are added back to the numerator for diluted EPS. In such cases, the shares may be antidilutive even if the market price of common shares exceeds the assumed proceeds.	

6.8.30 Interpretive analysis and examples

For additional relevant illustrations of the guidance in this section, see Example 6.10.30.

Question 6.8.10

How are the basic and diluted EPS denominators affected by unvested shares with a performance condition?

Interpretive response:

Basic EPS

Unvested shares subject to a performance condition are not included in the denominator of the basic EPS calculation until the performance condition has been satisfied. This is because the shares are deemed to be contingently issuable shares. [260-10-45-13]

Diluted EPS

Shares whose issuance is contingent upon the satisfaction of performance conditions are considered outstanding and included in the calculation of diluted EPS as follows. [260-10-45-13, 45-32, 45-48]

— If all necessary conditions have been satisfied by the end of the period (the events have occurred), the shares are included as of the beginning of the period in which the conditions were satisfied, or as of the date of the contingent share agreement, if later, and until such date as the shares are included in basic EPS.

— If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS is based on the number of shares, if any, that would be issuable if the end of the reporting period were the end of the contingency period (e.g. the number of shares that would be issuable based on current period earnings or period-end market price) and if the result would be dilutive. Those contingently issuable shares are included in the denominator of diluted EPS as of the beginning of the period, or as of the date of the contingent share agreement, if later.

If the unvested shares are subject to both a performance condition and a service condition, the service condition is generally presumed to be met for diluted EPS purposes, but the performance condition has to be evaluated under the contingently issuable shares guidance (see section 6.9.50).

Therefore, if the performance condition is satisfied at an earlier date than the service condition (or considered satisfied based on the guidance above), the shares are included in diluted EPS from the beginning of the period in which the performance condition is satisfied (or as of the date of the contingent share agreement, if later), irrespective of the service condition.

Example 6.8.10
Nonvested shares that vest on achievement of a performance condition

On January 1, Year 1, ABC Corp. grants 15,000 nonvested shares to its employees.

Performance condition – Scenario 1

The shares contain a performance condition such that the shares vest if ABC's cumulative net income from Years 1 to 4 equals or exceeds $10 million. The contingency is met during Year 3. There are no other contingencies related to the issuance of these shares.

	Year 1	Year 2	Year 3	Year 4
Basic	–[1]	–[1]	–[1]	–[1]
Diluted	–	–	15,000[1]	15,000[1]

Note:

1. The denominator in the basic EPS calculation does not reflect the shares outstanding until the contingency is met. The denominator in the diluted EPS calculation will be less than 15,000 due to the determination of assumed proceeds under the treasury stock method. Those calculations are not shown in this example.

Performance condition – Scenario 2

The nonvested shares vest on achievement of an average of $10 million of net income for Years 1 and 2 and providing four years of service. However, the award vests 50% at the end of Year 2 if the performance condition is met, and 25% at the end of Year 3 and Year 4. In scenario 2, the shares included in the denominator of the basic and diluted EPS are calculated as follows.

	Year 1	Year 2	Year 3	Year 4
Basic	–	–	7,500	11,250
Diluted	–	15,000[1]	15,000[1]	15,000[1]

Note:

1. The denominator in the basic EPS calculation reflects the shares that would be outstanding as of the beginning of Years 3 and 4. The denominator in the diluted EPS calculation will be less than 15,000 because of the determination of assumed proceeds under the treasury stock method. Those calculations are not shown in this example.
   - **Number of shares in denominator for basic EPS.** 7,500 shares vest at the end of Year 2 if the performance condition is met. These shares are included in basic EPS for Year 3. An additional 3,750 shares vest at the end of Year 3, which are included in basic EPS for Year 4.
   - **Number of shares in denominator for diluted EPS.** Once the performance condition is met, the shares are included in diluted EPS, from the beginning of the period, if the shares are dilutive.

Question 6.8.20

How is diluted EPS affected by unvested shares subject to a performance condition and that vest over multiple reporting periods?

Interpretive response: Diluted EPS reflects only those awards that would be issued if the end of the reporting period were the end of the contingency period, and if the resulting shares are dilutive. When evaluating the contingency, Topic 260 specifies that an entity assumes that the current amount of earnings, or status of the contingency, would remain unchanged until the end of the contingency period. [260-10-45-48, 45-51]

For example, ABC Corp. issues unvested shares to its employees whereby an additional two million shares will be issued to employees for each year during a three-year period that annual earnings exceed $10 million. Earnings at the end of Year 1 are $11 million and exceeded the $10 million target because of fourth quarter operating results.

In our experience, the number of awards assumed as outstanding at the end of Year 1 depends on an entity's accounting policy election as to whether it views each of the three years as discrete contingency periods (and one cannot begin until the other is complete), or one single contingency with separate measurement dates (and would therefore treat the end of Year 1 as if it were the end of the contingency period for all measurement dates). No projection of future results is made under either view.

View A

If ABC views the arrangement as three discrete contingencies, two million shares are added to the denominator for Year 1's diluted EPS calculation because Year 1's contingency has been met, but no additional shares would be assumed as outstanding for the earnings contingencies in Years 2 and 3. Under this view, where the three years are viewed as having discrete contingencies, the second and third years' criteria have not been met because those contingency periods have not even begun.

View B

If ABC views the arrangement as a single contingency with different measurement dates, it measures Year 2 and Year 3's contingencies as of the end of Year 1. ABC assumes the contingency is met as if the last day of Year 1 were the last day of the contingency period (i.e. end of Years 2 and 3) because earnings for Year 1 are $11 million. Consequently, ABC assumes that all six million shares would be issued at the beginning of Year 1.

6.9 Options, warrants and forward sale contracts

See Appendix A for guidance that applies before adoption of ASUs 2020-06 and 2021-04.

Excerpt from ASC 260-10

• > Variable Denominator

45-21A Changes in an entity's share price may affect the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument. For example, when the principal of a convertible debt instrument is required to be settled in cash but the conversion premium is required to (or may) be settled in shares, the number of shares to be included in the diluted EPS denominator is affected by the entity's share price. In applying both the treasury stock method and the if-converted method of calculating diluted EPS, the average market price shall be used for purposes of calculating the denominator for diluted EPS when the number of shares that may be issued is variable, except for contingently issuable shares within the scope of the guidance in paragraphs 260-10-45-48 through 45-57. See paragraphs 260-10-55-4 through 55-5 for implementation guidance on determining an average market price.

• > Options, Warrants, and Their Equivalents and the Treasury Stock Method

45-22 The dilutive effect of outstanding call options and warrants (and their equivalents) issued by the reporting entity shall be reflected in diluted EPS by application of the treasury stock method unless the provisions of paragraphs 260-10-45-35 through 45-36 and 260-10-55-8 through 55-11 require that another method be applied. Equivalents of options and warrants include nonvested stock granted under a share-based payment arrangement, stock purchase contracts, and partially paid stock subscriptions (see paragraph 260-10-55-23). Antidilutive contracts, such as purchased put options and **purchased call options**, shall be excluded from diluted EPS.

45-23 Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. (See paragraphs 260-10-45-29 and 260-10-55-4 through 55-5.)
c. The incremental shares (the 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.

Example 15 (see paragraph 260-10-55-92) provides an illustration of this guidance. See paragraph 260-10-45-21A if the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument is variable.

45-25 Options and warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are in the money). Previously reported EPS data shall not be retroactively adjusted as a result of changes in market prices of common stock.

45-26 Dilutive options or warrants that are issued during a period or that expire or are cancelled during a period shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive options or warrants exercised during the period shall be included in the denominator for the period prior to actual exercise. The common shares issued upon exercise of options or warrants shall be included in the denominator for the period after the exercise date. Consequently, incremental shares assumed issued shall be weighted for the period the options or warrants were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

45-27 Paragraphs 260-10-55-3 through 55-11 provide additional guidance on the application of the treasury stock method.

• > Options and Warrants and Their Equivalents

55-6 Options or warrants to purchase convertible securities shall be assumed to be exercised to purchase the **convertible security** whenever the average prices of both the convertible **security** and the common stock obtainable upon conversion are above the **exercise price** of the options or warrants. However, exercise shall not be assumed unless conversion of similar outstanding convertible securities, if any, also is assumed. The treasury stock method shall be applied to determine the incremental number of convertible securities that are assumed to be issued and immediately converted into common stock. Interest or dividends shall not be imputed for the incremental convertible securities because any imputed amount would be reversed by the if-converted adjustments for assumed conversions.

55-7 Paragraphs 260-10-55-9 through 55-11 provide guidance on how certain options and warrants should be included in the computation of diluted EPS. Exercise of the potential common shares discussed in those paragraphs shall not be reflected in diluted EPS unless the effect is dilutive. Those potential common shares will have a dilutive effect if either of the following conditions is met:

a. The average market price of the related common stock for the period exceeds the exercise price.
b. The security to be tendered is selling at a price below that at which it may be tendered under the option or warrant agreement and the resulting discount is sufficient to establish an effective exercise price below the market price of the common stock obtainable upon exercise.

55-8 When several conversion alternatives exist, the computation shall give effect to the alternative that is most advantageous to the holder of the convertible security. Similar treatment shall be given to **preferred stock** that has similar provisions or to other securities that have conversion options that permit the investor to pay cash for a more favorable **conversion rate**.

55-9 Options or warrants may permit or require the tendering of debt or other securities of the issuer (or its parent or its **subsidiary**) in payment of all or a portion of the exercise price. In computing diluted EPS, those options or warrants shall be assumed to be exercised and the debt or other securities shall be assumed to be tendered. If tendering cash would be more advantageous to the option holder or warrant holder and the contract permits tendering cash, the treasury stock method shall be applied. Interest (net of tax) on any debt assumed to be tendered shall be added back as an adjustment to the numerator. The numerator also shall be adjusted for any nondiscretionary adjustments based on income (net of tax). The treasury stock method shall be applied for proceeds assumed to be received in cash.

55-10 The underlying terms of certain options or warrants may require that the proceeds received from the exercise of those securities be applied to retire debt or other securities of the issuer (or its parent or its subsidiary). In computing diluted EPS, those options or warrants shall be assumed to be exercised and the proceeds applied to purchase the debt at its average market price rather than to purchase common stock under the treasury stock method. The treasury stock method shall be applied, however, for excess proceeds received from the assumed exercise. Interest, net of tax, on any debt assumed to be purchased shall be added back as an adjustment to the numerator. The numerator also shall be adjusted for any nondiscretionary adjustments based on income (net of tax).

55-11 Convertible securities that permit or require the payment of cash by the holder of the security at conversion are considered the equivalent of warrants. In computing diluted EPS, the proceeds assumed to be received shall be assumed to be applied to purchase common stock under the treasury stock method and the convertible security shall be assumed to be converted under the **if-converted method**. See Example 11 (paragraph 260-10-55-78) for guidance on the effects of **contingently convertible instruments** on diluted EPS.

6.9.10 Overview of the instruments

For EPS purposes, 'options, warrants and their equivalents' (collectively, 'options' in this section) are financial instruments that give holders the right to purchase common shares. Options in this section are generally written calls that give holders the right, but not the obligation, to acquire an entity's common shares with cash and/or by providing goods or services. If an entity receives goods or services in exchange for the options, the transaction generally falls in the scope of Topic 718; other options are generally in the scope of Topic 815 (derivatives).

Share-based payment awards and forward sale contracts are also discussed in this section. Forward sale contracts differ from options and warrants in that they are contracts that will always be settled. The exercise (or settlement) of options and warrants is generally at the discretion of the holder, and therefore not always settled.

In addition, the instruments discussed in this section are those that may require settlement in common shares. An option that is always settled net in cash does not entitle its holder to common shares and therefore is ignored in the diluted EPS denominator because it is not a potential common share.

This section covers the EPS implications for options in general. Some instruments may require additional consideration, and are discussed in the following sections:

- written put options and forward purchase contracts, see section 6.15;
- purchased puts and calls, see section 6.16;
- options embedded in other financial instruments, see section 6.11;
- options subject to performance or market conditions other than service conditions, see section 6.10;
- options to purchase convertible instruments, see section 6.12; and
- instruments that may be settled in cash or shares, see section 6.13.

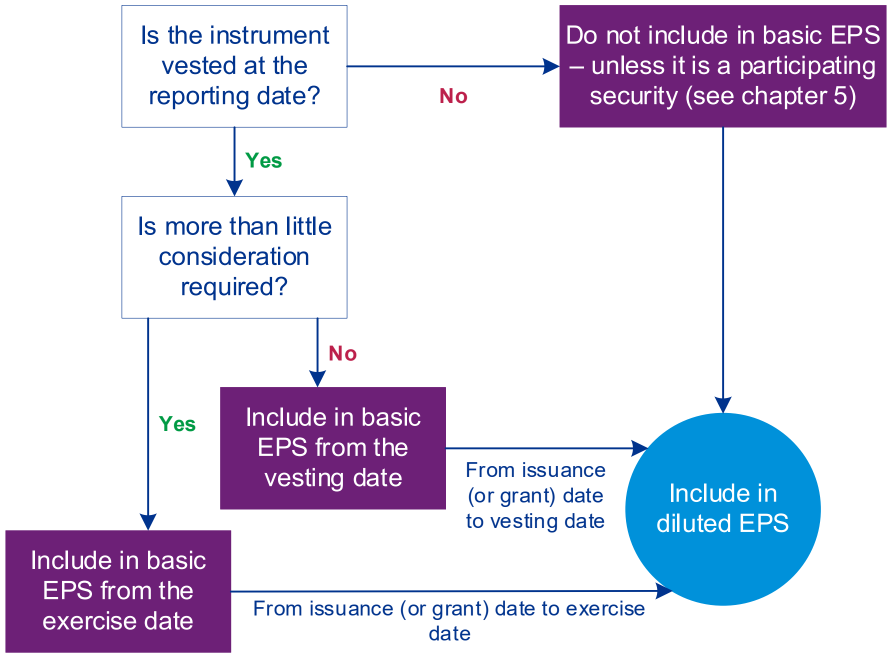
Additional considerations in the context of share-based payment awards are discussed in section 6.9.50 and chapter 5.

The EPS implications for an equity-linked financial instrument with a down-round feature are discussed in section 6.18.

6.9.20 EPS implications

Unless they are participating securities or are issuable for little or no consideration, options affect only diluted EPS.

Understanding the accounting for these options is relevant because it determines whether their assumed exercise would have a consequential effect on earnings. This is illustrated in the following decision tree.



Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator X / ✓	Numerator X / ✓ Denominator X / ✓
Options are generally ignored in basic EPS because they are not common shares. However, options exercisable for little or no consideration are included in the denominator from the vesting date (see section 3.4.30). [260-10-45-13] Forward sale contracts are ignored in basic EPS. However, if they are prepaid, the minimum amount of shares to be issued is included in basic EPS. See Question 6.15.30. A modification or exchange of a freestanding equity-classified option that does not represent a cost of financing or compensation in a reciprocal transaction is treated as a deemed dividend. The numerator in basic EPS is adjusted for the incremental fair value of the modified or exchanged option. See Question 6.9.50. [260-10-45-15]	Options are potential common shares. These instruments are assumed exercised and included in diluted EPS if they are in-the-money (i.e. the average market price of the related common shares for the period exceeds the exercise price). When determining if share-based payment awards are in-the-money, the average market price is compared to the overall proceeds per share, which includes the unearned compensation (see section 6.9.50). [260-10-55-7] The potential adjustment to the numerator depends on whether the options are accounted for under Topic 505 (equity), Topic 718 (share-based payments) or Topic 815 (derivatives and hedging), and their manner of settlement. If an instrument is classified as an asset or liability and measured at fair value, share settlement is required to be presumed (except for a liability-classified share-based payment award), and the fair value (i.e. mark-to-

<table>
<tr><th>Potential effect on basic EPS</th><th colspan="2">Potential effect on diluted EPS</th></tr>
<tr><td rowspan="4">Options and forward contracts that are participating securities are included in basic EPS using the two-class method. See chapter 5.</td><td colspan="2">market) amount is a numerator adjustment for EPS purposes.
The following table assumes share settlement.</td></tr>
<tr><td>Accounting for options</td><td>Potential numerator adjustment?</td></tr>
<tr><td>Equity</td><td>No</td></tr>
<tr><td>Liability</td><td>Yes</td></tr>
<tr><td></td><td colspan="2">For instruments that may be settled in cash or shares, see section 6.13.
For instruments with variable exercise prices, see section 4.4.40.
The potential adjustment to the denominator is determined using the treasury stock method. The potential shares are included only for the period in which they were outstanding – i.e. from the beginning of the period, or from the date on which the options are issued or granted if this is later. Also, options are not included for the period after which they are exercised (because they are already included in basic EPS) or forfeited. [260-10-45-26]
The denominator in the year-to-date period is calculated using an average of the quarterly denominators, as discussed in section 8.3.30.
Participating securities are included in diluted EPS using the more dilutive of the two-class method or the treasury stock method. See section 5.7.</td></tr>
<tr><td colspan="3">Dilutive or antidilutive?
Generally, options are dilutive if they are in-the-money – i.e. the total proceeds per share (including the fair value of any goods or services to be supplied to the entity in the future, and unearned compensation for share-based payment awards) is lower than the average market price of the common shares. However, for options that are accounted for as liabilities under Topic 718 or Topic 480, the numerator adjustment could vary and could therefore affect whether the options are dilutive. [260-10-45-25, 55-36A]
Forward sale contracts may be dilutive even if they are out-of-the-money from the counterparty's perspective – i.e. the price at the end of the reporting period is less than the contract price. This is because the treasury stock method uses the average market price during the period and not the price at the end of the reporting period to determine if there are incremental shares to be added to the denominator. Also, numerator adjustments could affect whether a forward is dilutive.</td></tr>
</table>

6.9.30 Denominator adjustment for options – the treasury stock method

Generally, the denominator for diluted EPS assumes that all dilutive potential common shares have been converted into common shares at the beginning of the period; or the date of issue of the potential common shares, if later. In addition, they are included in the denominator only for the period during which they are outstanding (see section 4.4.40).

In the context of freestanding options, instead of simply adding to the denominator the weighted-average number of common shares that would be issued from the assumed conversion of options, Topic 260 prescribes a specific method to determine the number of shares to add to the denominator. This method is commonly referred to as the 'treasury stock method' and is different from the method prescribed for options that are embedded in other financial instruments – e.g. convertible debt (see section 6.12). [260-10-45-22 – 45-23, 45-26]

The treasury stock method assumes the entity uses the proceeds it receives when the options are exercised (which are based on the exercise price) to repurchase shares at the average market price of a common share during the period. The difference between the number of common shares that would be issued at the exercise price and the number of common shares that would be repurchased at the average market price is referred to as the incremental shares. Only the incremental shares to be issued (i.e. the number calculated under Step (iii) below) are reflected in diluted EPS. The following diagram summarizes the treasury stock method. [260-10-45-23]

The treasury stock method

Step i	**Calculate the assumed proceeds** Calculate the proceeds that would have been received from the assumed exercise of all options.	'Exercise price' × number of options
Step ii	**Calculate the number of common shares deemed to be repurchased at average market price** Calculate the number of common shares that would have been repurchased if the proceeds received in Step (i) were used to acquire these shares at their average market price during the period.	Assumed proceeds ÷ average market price of shares
Step iii	**Determine the incremental shares** Calculate the difference between the number of common shares that would be issued at the exercise of the options and the number of common shares deemed to be repurchased at the average market price.	Number of shares that would be issued – number of shares deemed to be repurchased

The treasury stock method is discussed in further detail in section 4.4.40.

Applying the treasury stock method when an option's exercise price is settled wholly or partially in other instruments#

Some options may permit or require an entity to tender a debt or another instrument issued by it or its subsidiary in payment of all or a portion of the exercise price of the option.

These options may be dilutive if: [260-10-55-7]

— the average market price of the common shares for the period exceeds the exercise price; or

— the selling price of the instrument to be tendered is below that at which the instrument may be tendered under the option and the resulting discount establishes an effective exercise price that is below the market price of the common shares obtainable on exercise.

The exercise of the options and the tendering of the instruments are assumed for diluted EPS and included in diluted EPS if dilutive, unless tendering cash is more advantageous to the holder, in which case the treasury stock method is applied. After-tax interest on any debt assumed to be tendered and any nondiscretionary income adjustments are added to the numerator (see section 4.4.30).[260-10-55-9]

Question 6.9.20#

How is EPS affected by options when their exercise price is settled or partially settled in other instruments?

Interpretive response: While Topic 260 discusses the adjustment to the numerator of diluted EPS for such options, it does not explicitly specify how to calculate the effect of such options on the denominator. We believe the intention of Topic 260 is to use a similar approach to that for convertible instruments – i.e. the if-converted method (see section 4.4.20) instead of the treasury stock method; no proceeds are assumed to be received under the treasury stock method. This means that, for the portion for which the exercise price may be paid up by tendering debt or other instruments, the denominator should be adjusted for the total number of shares assumed to be issued for those options. For the portion for which the exercise will be paid in cash, the treasury stock method is used, and only the incremental shares are added to the denominator. [260-10-55-9]

Question 6.9.30

How is diluted EPS affected when the terms of an option require the exercise proceeds to be used to redeem debt or other instruments?

Interpretive response: In some cases, the terms of options require the proceeds received from exercise to be used to redeem debt or other instruments of the entity (or its parent or a subsidiary). In determining diluted EPS, it is assumed that the proceeds are used first to purchase these other instruments at their average market price. The numerator is adjusted by the after-tax interest savings on the assumed redemption and any nondiscretionary income adjustments (net of tax) (see section 4.4.40). If the proceeds to be received exceed the redemption amount, the excess is assumed to be used to purchase common shares under the treasury stock method. [260-10-55-10]

The EPS calculations for these types of options are illustrated in Example 6.9.20.

Question 6.9.40

How is EPS affected by options to purchase convertible instruments?

Interpretive response: Options or warrants to purchase convertible instruments (e.g. an option to purchase convertible preferred shares) may also be considered potential common shares. In many cases, these options do not meet the requirements for classification as equity instruments under Topic 505 and are accounted for as derivatives under Topic 815.

In such cases, the options are assumed to be exercised to purchase the convertible instrument and the convertible instrument is deemed to be converted into common shares when calculating diluted EPS only if: [260-10-55-6]

— the average price of the convertible instrument is above the exercise price of the option;
— the average price of the common shares obtainable on conversion is above the exercise price of the option; and
— the conversion of similar outstanding convertible instruments (if any) is also assumed.

Also, there may be a numerator adjustment to reverse the effect of fair value adjustments when marking the instrument to market because the instrument is deemed converted into common shares. This adjustment may affect whether an option is dilutive (see section 4.4).

To calculate the effect of these instruments on diluted EPS, because they are options, the treasury stock method is used in determining the effect on the denominator, assuming the option holders would exercise the options and then immediately convert the instrument received from the exercise to obtain common shares (see section 6.9). The after-tax consequential changes in income or expense are adjusted in the numerator, using the if-converted method (see section 4.4.20). Interest or dividends on the incremental convertible securities are not imputed because these would just be reversed when applying the if-converted method. [260-10-55-6]

If there are multiple exercise or conversion alternatives, an entity applies the guidance in Topic 260 on multiple conversion bases (see section 4.4.40).

The EPS calculations for options to purchase convertible instruments are illustrated in Example 6.9.30.

Question 6.9.50

How is EPS affected by a modification of equity-classified options?

Excerpt from ASC 260-10

> Basic EPS

• > Issuer's Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

45-15 For a modification or an exchange of a freestanding equity-classified written call **option** described in paragraph 815-40- 35-17(d), an entity shall deduct the effect of the modification or exchange (as measured in accordance with paragraph 815-40-35-16) in computing income available to common stockholders when the modification or exchange is executed by the issuer and the holder or unilaterally by the issuer (see paragraph 815-40-15-7H).

Interpretive response: As discussed in section 3.3.60, a modification or exchange of a freestanding equity-classified option (or warrant) that does not represent a cost of financing or compensation in a reciprocal transaction is treated as a deemed dividend. The numerator in basic EPS is adjusted for the incremental fair value of the modified or exchanged option. The deemed dividend is reversed in calculating diluted EPS. See section 3.3.60 and Example 6.9.34. [260-10-45-15]

Question 6.9.55

How is the treasury stock method applied when there is a cashless exercise (i.e. net share settlement) provision that may be elected to cover the exercise price?

Background: Cashless exercise (i.e. net-share settlement) upon settlement permits the holder of the instrument to pay the exercise price and tax withholdings (if applicable) in shares, and receive the net amount of shares, after deducting those used for the exercise price and tax withholdings. A cashless exercise is similar to two transactions occurring simultaneously: gross settlement of the instrument and an immediate repurchase from the holder of the issued shares in an amount that covers the cost of the exercise price and tax withholdings.

Interpretive response: When net-share settlement is optional (an election), the treasury stock method is applied in the normal manner, assuming gross settlement and using the average market price of the shares in the calculation. The repurchase of shares for the exercise or forward price (net-share settlement feature) is ignored. This is done in keeping with the principles of using an average market price in the treasury stock method, even though net-share settlement, if elected, may be based on the current market price of the shares.

However, when net-share settlement is required (not an election), the net shares to be issued are instead considered contingently issuable shares and the amount of shares to be included in diluted EPS is calculated based on the terms of the contract (e.g. current market price).

6.9.40 Interpretive analysis and examples

Example 6.9.10
Options settled gross in shares

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

ABC has the following equity-classified stock options issued to investors (third parties).

Terms	Option A	Option B	Option C
Total number of options	200,000	1,250,000	500,000
Issuance (and vesting) date	Before January 1, Year 1	Before January 1, Year 1	July 1, Year 1
Options exercised	–	500,000 on December 31	–
Exercise price per option	(no consideration)	$10	$20

Each option is exercisable for one common share, and the options do not entitle the holders to dividends before they are exercised.

The following information is also relevant.

- The average market prices of ABC's common shares are:
  - Year-end December 31: $15
  - Six months ended December 31 (for Option C): $16
- Net income for Year 1 is $4,600,000.

ABC reports only on an annual basis (i.e. does not prepare interim financial statements).

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,200,000	3,616,667
EPS	$1.44	$1.27

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

Because the options under Option A are vested and exercisable for little or no further consideration, they are included in the denominator from the vesting date – i.e. included throughout the year.

The options under Options B and C are ignored in basic EPS until they are actually exercised, because the exercise price is more than little consideration.

ABC calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Common shares outstanding	3,000,000		
Vested options exercisable for no consideration	200,000		
Jan. – Dec.	3,200,000	12/12	3,200,000
Dec. 31: options exercised	500,000		
Dec. 31	3,700,000	0/12	0
		12/12	
Weighted average for the year			**3,200,000**

Therefore, the denominator is 3,200,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,200,000 = $1.44

Diluted EPS

1 Identify potential common shares

Although the options under Option A have not been converted into common shares during the year, they have been included in basic EPS throughout the period because they can be exercised for no further consideration and they were vested for the full period. Therefore, they are not potential common shares throughout the year.

Unlike the options under Option A, those under Options B and C are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the options are classified as equity (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

		Option B	***Option C***	
Step i	Weighted-average number of options (and shares to be issued on exercise of the options)[1]	1,250,000	250,000	(A)
	Exercise price	$10	$20	(B)
	Assumed proceeds	**$12,500,000**	**$5,000,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$15	$16	(D)
	Number of common shares deemed repurchased	**833,333**	**312,500**	(E) = (C) ÷ (D)
Step iii	**Incremental shares[2]**	**416,667**	-	(A) – (E)

Notes:

1. In this step, the weighted-average number of options under Option B reflects the exercise of 500,000 options on December 31: (1,250,000 × 12) + (500,000 × 0) ÷ 12 = 1,250,000. The weighted-average number of options under Option C reflects the fact that the options were issued on July 1: 500,000 × 6 ÷ 12 = 250,000.
2. The options under Option C are antidilutive and therefore are ignored in the denominator; this is because the exercise price is higher than the average market price for the period during which these options are outstanding.

3 Rank the potential common shares

This step does not apply. Because the options under Option C are antidilutive, the options under Option B are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.44 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The options under Option B are dilutive because no adjustment to the numerator for EPIS is required and the exercise price is lower than the average market price of a common share during the period.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,200,000	$1.44	
Incremental shares in Option B	-	416,667		
Total	**$4,600,000**	**3,616,667**	$1.27	✓

Therefore, ABC includes the effect of the Option B options in diluted EPS.

Diluted EPS = $1.27

Example 6.9.15
Options with variable exercise price

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issued 1,250,000 stock options to investors in connection with a private placement offering. The exercise price varies as follows.

If exercised by:	Then exercise price is:
January 1, Year 2	$20
January 1, Year 3	$18
January 1, Year 4	$15
January 1, Year 5	$10

The following information is also relevant.

— Each option is exercisable for one common share, and the options do not entitle the holders to dividends before they are exercised.

— The average market price of ABC's common shares during the year was $15.
— Net income for Year 1 is $4,600,000.

ABC reports only on an annual basis (i.e. does not prepare interim financial statements).

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,416,667
EPS	$1.53	$1.35

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than a little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

Options are exercisable for more than a little consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the options are classified as equity (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows. Because the exercise price varies only with time, the entity uses the most advantageous price available to the holder at any point in time (see section 4.4.40). In this case, it is $10. [260-10-45-21]

Step i	Weighted-average number of options (and shares to be issued on exercise of the options)	1,250,000	(A)
	Exercise price	$10	(B)
	Assumed proceeds	**$12,500,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$15	(D)
	Number of common shares deemed repurchased	**833,333**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**416,667**	(A) – (E)

Because there is no numerator adjustment, EPIS is 0.

3 Rank the potential common shares

This step does not apply because the options are the only class of potential common shares outstanding.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The options are dilutive because no adjustment to the numerator for EPIS is required and the exercise price is lower than the average market price of a common share during the period.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares in Option B	-	416,667		
Total	**$4,600,000**	**3,416,667**	$1.35	✓

Therefore, ABC includes the effect of the options in diluted EPS.

Diluted EPS = $1.35

Example 6.9.20

Proceeds used to redeem debt or other instruments of the entity

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 200,000 equity-settled options. Each option may be exercised to purchase one common share for $100.

The holders of these options also own 60,000 bonds issued by ABC. The terms of the options require ABC to use the exercise proceeds to repurchase these bonds.

- The average market price of ABC's common shares during Year 1 is $95, and the average market price of each bond during Year 1 is $90.
- Net income for Year 1 is $4,600,000, which includes interest expense of $250,000 on the bonds. The interest expense is tax deductible, and the applicable income tax rate is 21%.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,000,000
EPS	$1.53	$1.53

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

Options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

It is assumed that the proceeds from the exercise price would be used to repurchase the bonds. Therefore, $5,400,000 [60,000 × $90] of the total proceeds of $20,000,000 [200,000 × $100] is not considered as assumed proceeds in applying the treasury stock method.

Potential adjustment to the numerator for EPIS: The redemption of the bonds would increase income for the year by the post-tax amount of the interest expense:

> (interest expense on the bonds) × (1 – income tax rate) = ($250,000) × (1 – 21%) = $197,500

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows. Only the proceeds exceeding the assumed repurchase of the bonds are used.

Step i	Number of options (and shares to be issued on exercise of options)	200,000	(A)
	Exercise price	$100	(B)
	Proceeds used to redeem outstanding bonds	(5,400,000)	(C)
	Assumed proceeds	**14,600,000**	(D) = ((A) × (B)) – (C)
Step ii	Average market price of common shares	$95	(E)
	Number of common shares deemed repurchased	**153,684**	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	**46,316**	(A) – (F)

EPIS is therefore $197,500 ÷ 46,316 = $4.26

3 Rank the potential common shares

This step does not apply, because the options are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Options exercised by tendering notes	197,500	46,316		
Total	**$4,797,500**	**3,046,316**	$1.57	✘

To the extent that the options are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

Diluted EPS = $1.53

Example 6.9.25
Options exercised by tendering other instruments of the entity

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 200,000 equity-settled options. Each option may be exercised to purchase one common share for $100.

The holders of these options also own 60,000 bonds issued by ABC. The terms of the options permit the holder to tender the bonds in lieu of cash when exercising the options.

— The average market price of ABC's common shares during Year 1 is $95, and the par value of each bond is $90. The bonds are trading at par.

— Net income for Year 1 is $4,600,000, which includes interest expense of $250,000 on the bonds. The interest expense is tax deductible, and the applicable income tax rate is 21%.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,000,000
EPS	$1.53	$1.53

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

Options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

It is assumed that bonds will be tendered to partially satisfy the exercise price (because there is no advantage to tendering cash). Therefore, $5,400,000 [60,000 × $90] of the total proceeds of $20,000,000 [200,000 × $100] is not considered as assumed proceeds in applying the treasury stock method.

Potential adjustment to the numerator for EPIS: Tendering of the bonds would increase income for the year by the post-tax amount of the interest expense:

> (interest expense on the bonds) × (1 – income tax rate) = ($250,000) × (1 – 21%) = $197,500

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows. Only the proceeds exceeding the tendered value of the bonds are used.

Step i	Number of options (and shares to be issued on exercise of options)	200,000	(A)
	Exercise price	$100	(B)
	Bond value tendered	($5,400,000)	(C)
	Assumed proceeds	**$14,600,000**	(D) = ((A) × (B)) – (C)

Step ii	Average market price of common shares	$95	(E)
	Number of common shares deemed repurchased	**153,684**	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	**46,316**	(A) – (F)

EPIS is therefore $197,500 ÷ 46,316 = $4.26

3 Rank the potential common shares

This step does not apply, because the options are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Options exercised by tendering bonds	197,500	46,316		
Total	**$4,797,500**	**3,046,316**	$1.57	✘

To the extent that the options are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

Diluted EPS = $1.53

Observation

Options exercised by tendering other instruments of the entity

As seen in Example 6.9.25, when a holder of a convertible instrument has all of the following, the calculation (and result) is the same as if the holder were *required* to tender the instrument (see Example 6.9.20):

- the option to tender either the instrument or cash upon exercise;
- it is assumed that the holder will tender the instrument; and
- the fair value of the instrument equals its par value.

Example 6.9.30
Options over convertible preferred shares

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 500,000 options over convertible noncumulative nonparticipating preferred shares.

- Each option is to acquire one convertible preferred share at an exercise price of $50. Each preferred share is convertible into two common shares.
- The options are classified as derivatives. The expense for remeasurement of the options at fair value is $100,000 for the year. The remeasurement expense is tax-deductible, and the applicable income tax rate is 21%.
- There are no other similar convertible preferred shares outstanding.

The following average prices are also relevant for the period:

- market price of convertible preferred shares: $65
- market price of ABC's common shares: $30.

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,679,000
Denominator	3,000,000	3,166,667
EPS	$1.53	$1.48

Basic EPS

1 Determine the numerator

No adjustment is necessary until the options are exercised and dividends are declared on the convertible preferred shares. The numerator is $4,600,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The options over convertible preferred shares are the only potential common shares.

2 For each potential common share, calculate EPIS

— The exercise price per convertible preferred share [$50] is lower than its average market price [$65].
— The exercise price per common share on conversion [$50 × 500,000 ÷ 1,000,000 = $25] is lower than its average market price [$30].
— There is no similar outstanding convertible instrument.

Therefore, the exercise of the options is assumed because they are in-the-money.

Potential adjustment to the numerator for EPIS: The options, if exercised, would increase income for the year by the after-tax amount of the remeasurement expense:

(remeasurement expense on the options) × (1 – income tax rate) = ($100,000) × (1 – 21%) = $79,000

Potential adjustment to the denominator for EPIS: Calculate the effect using the treasury stock method as follows.

Step i	Number of options	500,000	(A)
	Exercise price	$50	(B)
	Assumed proceeds	**$25,000,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$30	(D)
	Number of common shares deemed repurchased	**833,333**	(E) = (C) ÷ (D)
Step iii	Common shares to be issued per option	2[1]	(F)
	Common shares to be issued on conversion	1,000,000	(G) = (F) × (A)
	Incremental shares	**166,667**	(G) – (E)

Note:
1. Each option is exercisable into one convertible noncumulative preferred share, which, in turn, is convertible into two common shares.

EPIS is therefore $79,000 ÷ 166,667 = $0.47

3 Rank the potential common shares

This step does not apply because the options over the convertible preferred shares are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of options over convertible preferred shares is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares from options over convertible preferred shares	79,000	166,667		
Total	**$4,679,000**	**3,166,667**	$1.48	✓

Therefore, ABC includes the options over convertible preferred shares in diluted EPS.

Diluted EPS = $1.48

Example 6.9.32
Liability-classified warrants exercised during the year

ABC Corp. has 3,000,000 weighted-average common shares outstanding and net income of $4,600,000 during Year 1.

On January 1, Year 1, ABC issues warrants to buy 600,000 common shares at $11.50 per share.

- The warrants are classified as a liability under Subtopic 815-40.
- The warrants are required to be settled in shares.
- The warrants contingently participate in distributions, but none of the contingencies were met during Year 1.
- The warrants were fully exercised on September 1, Year 1.

The following information is also relevant.

- ABC records expense of $1,200,000 (after-tax) during the year due to changes in the fair value of the warrants.
- The average market price of ABC's common shares during Year 1 is $17/share.
- The warrant holders are not entitled to dividends.

EPS calculations –Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,200,000	3,200,000
EPS	$1.44	$1.44

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

The warrants are ignored in basic EPS until they are actually exercised.

ABC calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Jan.- Aug.	3,000,000	8/12	2,000,000
Sept. 1: warrants exercised	600,000		
Dec. 31	3,600,000	4/12	1,200,000
		12/12	
Weighted average for the year			**3,200,000**

Therefore, the denominator is 3,200,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,200,000 = $1.44

Diluted EPS

1 Identify potential common shares

The warrants are potential common shares for the period during which they are outstanding (i.e. before they were exercised).

2 For each potential common share, calculate EPIS

The contract is settleable in common shares, and therefore the effect of the liability classification is reversed as a numerator adjustment.

Potential adjustment to the numerator for EPIS: The exercise of the warrants would increase income for the year by the fair value adjustment (after-tax) of $1,200,000.

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Weighted-average number of warrants (and shares to be issued on exercise of the warrants)[1]	400,000	(A)
	Exercise price	$11.50	(B)
	Assumed proceeds	**$4,600,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$17	(D)
	Number of common shares deemed repurchased	**270,588**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**[2]	**129,412**	(A) – (E)

Notes:

1. In this step, the weighted-average number of warrants reflects the exercise of 600,000 options on September 1: ((600,000 × 8) + (0 × 4)) ÷ 12 = 400,000.
2. [400,000 – 270,588]

3 Rank the potential common shares

This step does not apply. The warrants are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.44 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the warrants is as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,200,000	$1.44	
Warrants	1,200,000	129,412		
Total	**$5,800,000**	**3,329,412**	$1.74	✘

The warrants are antidilutive because they increase EPS.

Therefore, diluted EPS is the same as basic EPS = $1.44.

Question 6.9.60

How is diluted EPS calculated when parent options will be exchanged for subsidiary options in connection with a spinoff or carve-out?

Interpretive response: In calculating diluted EPS for a spinoff or carve-out, if parent options will be exchanged for subsidiary options as part of the initial capitalization of the entity, the exchanged options should generally be treated as subsidiary options in historical calculations of diluted EPS. However, we believe if options are later exchanged, the exchange should be included in diluted EPS only prospectively from the date it occurs.

Example 6.9.34

Modification of freestanding equity-classified options

ABC Corp. has 3,000,000 common shares outstanding. On January 1, Year 1, ABC issues 100,000 options.

The following facts are relevant.

- The options have a 10-year term and permit the holders to buy common shares for $10 per share and are exercisable at any time.
- Each option can be exercised in exchange for five common shares.
- ABC has no other potential common shares.
- The options are equity-classified.

During Year 2, in light of changes in the market, ABC wishes to induce early exercise of the options and reduces the exercise price to $8 each.

- The modification does not represent a cost of financing or compensation.
- The incremental fair value of the options is calculated as $100,000.
- The average market price during the year of ABC's common shares is $9.
- Net income is $4,600,000 in Year 2.

EPS calculations – Year 2

Because the options are equity-classified freestanding financial instruments, the incremental fair value of the options following the modification is treated as a deemed dividend and deducted from income available to common shareholders upon the date the feature is triggered when calculating basic EPS. That value is added back for the purposes of calculating diluted EPS.

EPS at a glance

	Basic	Diluted
Numerator	$4,500,000	$4,600,000
Denominator	3,000,000	3,055,000
EPS	$1.50	$1.47

Basic EPS

1 Determine the numerator

The numerator is adjusted for the deemed dividend. ABC calculates the numerator as follows: $4,600,000 – 100,000 = $4,500,000.

2 Determine the denominator

No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than little consideration. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,500,000 ÷ 3,000,000 = $1.50

Diluted EPS

1 Identify potential common shares

The options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The adjustment for the deemed dividend included in basic EPS is added back in the diluted calculation.

$4,500,000 + $100,000 = $4,600,000

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9.30), as follows.

Step i	Weighted-average number of options (and shares to be issued on exercise of options)[1]	500,000	(A)
	Exercise price	$8	(B)
	Assumed proceeds[2]	**$4,000,000**	(C) = (A) × (B)

Step ii	Average market price of common shares	$9	(D)
	Number of common shares deemed issued	**444,444**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**55,555**	(A) – (E)

Notes:
1. 100,000 × 5 = 500,000 for 12/12 months
2. Assumed proceeds of 100,000 options at $8 exercise price × 5 shares = $4,000,000

EPIS is therefore $100,000 ÷ 55,555 = $1.80

3 Rank the potential common shares

This step does not apply because the options are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.50 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,500,000	3,000,000	$1.50	
Options	100,000	55,555		
Total	**$4,600,000**	**3,055,000**	$1.47	✓

Therefore, the options are included in diluted EPS.

Diluted EPS = $1.47

Example 15 in Topic 260 (reproduced below) also illustrates the treatment for options, warrants and their equivalents.

Excerpt from ASC 260-10

• > Example 15: Options, Warrants, and Their Equivalents

55-92 This Example illustrates the guidance in paragraphs 260-10-45-22 through 45-23.

55-93 Consider Entity A that has 10,000 warrants outstanding exercisable at $54 per share; the average market price of the common stock during the reporting period is $60. Exercise of the warrants and issuance of 10,000 shares of common stock would be assumed. The $540,000 that would be realized from exercise of the warrants ($54 × 10,000) would be an amount sufficient to acquire 9,000 shares ($540,000/$60). Thus, 1,000 incremental shares (10,000 – 9,000) would be added to the outstanding common shares in computing diluted EPS for the period.

55-94 The following is a shortcut formula for that computation (note that this formula may not be appropriate for stock-based compensation awards [see paragraph 260-10-45-29]):

Incremental shares = [(market price – exercise price)/market price] × shares assumed issued under option; thus, [($60 – $54)/$60] × 10,000 = 1,000 incremental shares.

6.9.50 Share-based payment awards

Excerpt from ASC 260-10

• • > Share-Based Payment Arrangements

45-28 The provisions in paragraphs 260-10-45-28A through 45-31 apply to share-based awards issued to grantees under a share-based payment arrangement in exchange for goods and services.

45-28A Awards of share **options** and nonvested shares (as defined in Topic 718) to be issued to a grantee under a share-based compensation arrangement are considered options for purposes of computing diluted EPS. Such share-based awards shall be considered to be outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent upon vesting. Those share-based awards are included in the diluted EPS computation even if the grantee may not receive (or be able to sell) the stock until some future date. Accordingly, all shares to be issued shall be included in computing diluted EPS if the effect is dilutive. The dilutive effect of share-based payment arrangements shall be computed using the **treasury stock method**. If the equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding. See Example 8 (paragraph 260-10-55-68).

45-29 In applying the treasury stock method described in paragraph 260-10-45-23, the assumed proceeds shall be the sum of both of the following:

a. The amount, if any, the grantee must pay upon exercise.
b. The amount of cost attributed to share-based payment awards (within the scope of Topic 718 on stock compensation) not yet recognized. This amount includes share-based payment awards that are not contingent upon satisfying certain conditions as described in paragraph 260-10-45-32 and contingently issuable shares that have been determined to be included

in the computation of diluted EPS as described in paragraphs 260-10-45-48 through 45-57

c. [Subparagraph superseded by Accounting Standards Update No. 2016-09].

45-29A Under paragraphs 718-10-35-1D and 718-10-35-3, the effect of forfeitures is taken into account by recognizing compensation cost for those instruments for which the employee's requisite service has been rendered or the nonemployee's vesting conditions have been met and no compensation cost shall be recognized for instruments that grantees forfeit because a service or performance condition is not satisfied. See Example 8 (paragraph 260-10-55-68) for an illustration of this guidance.

45-30 If stock-based payment arrangements are payable in common stock or in cash at the election of either the entity or the grantee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 260-10-45-45. If an entity has a tandem award (as defined in Topic 718) that allows the entity or the grantee to make an election involving two or more types of equity instruments, diluted EPS for the period shall be computed based on the terms used in the computation of compensation cost for that period.

45-31 Awards with a market condition, a performance condition, or any combination thereof (as defined in Topic 718) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 260-10-45-48 through 45-57.

45-32 Fixed grantee stock options (fixed awards) and nonvested stock (including restricted stock) shall be included in the computation of diluted EPS based on the provisions for options and warrants in paragraphs 260-10-45-22 through 45-27. Even though their issuance may be contingent upon vesting, they shall not be considered to be contingently issuable shares (see Section 815-15-55 and paragraph 260-10-45-48). However, because issuance of performance-based stock options (and performance-based nonvested stock) is contingent upon satisfying conditions in addition to the mere passage of time, those options and nonvested stock shall be considered to be contingently issuable shares in the computation of diluted EPS. A distinction shall be made only between time-related contingencies and contingencies requiring specific achievement.

In general, the EPS treatment of share-based payment awards is based on the guidance in Topic 260 for the relevant instrument – e.g. options, contingent shares. Unvested shares are treated similarly to options for purposes of calculating diluted EPS. [260-10-45-28 – 45-28A]

Share-based payment awards that must be settled in cash and will never result in the issuance of common shares, are excluded from EPS calculations. Awards that may be settled in cash or shares are included in EPS following the guidance for those instruments in section 6.13.20.

Basic EPS

Unvested share-based payment awards generally do not affect basic EPS unless they are participating securities – in which case, the two-class method is used (see chapter 5). Vested awards may affect basic EPS depending on the type of instrument.

— Stock awards (unvested stock, RSUs) are considered outstanding common shares and included in basic EPS from the date the awards are vested, and services are received, or goods are delivered. This is consistent with the treatment of contingently issuable shares (see section 6.10.20), whereby the shares are included when there are no circumstances, other than the passage of time, under which they would not be issued. [260-10-45-12C – 45-13]

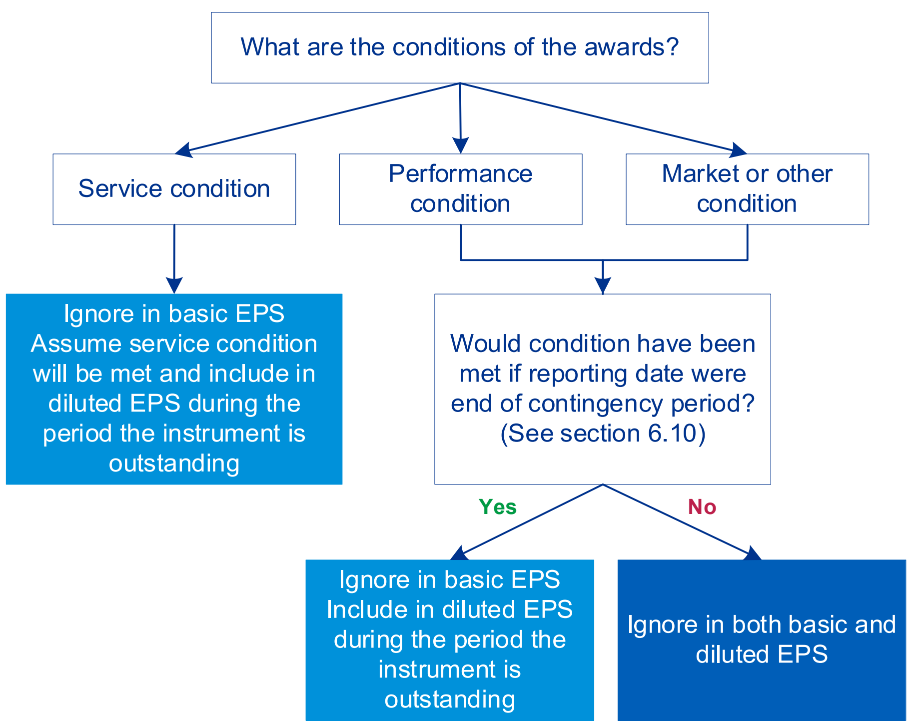
— Options or warrants are generally not considered outstanding common shares until exercised, even if they are vested. See the discussion in sections 6.8 (unvested common shares) and 6.9.20 (options and warrants).

Diluted EPS

Share-based payment awards that are not included in basic EPS (or if included in basic EPS, for periods before they are included) are considered for diluted EPS even if they are not vested or cannot be exercised, if they are in the money (see section 6.9.20). Generally, share-based payment awards whose vesting is contingent only on future service (service condition) are included in diluted EPS assuming the service condition will be met. Share-based payment awards with performance or market conditions are evaluated under the contingency guidance discussed in sections 6.10 and 6.11. See also Examples 6.10.10 and 6.10.11. Estimated forfeitures are ignored in diluted EPS (see Question 6.9.70). [260-10-45-28A, 45-29A]

The following diagram highlights the EPS considerations for evaluating the various conditions in share-based payment awards.

See section 6.10 for examples of EPS for share-based payment awards with performance and market conditions.



A modified treasury stock method applies to share-based payment awards with a service condition. Under the modified method, the assumed proceeds from exercise of the award includes the average unrecognized compensation cost during the period on the options. Therefore, the assumed proceeds are calculated as: [260-10-45-29]

$$\text{Assumed proceeds from exercise of award} + \text{Average unrecognized compensation cost} = \text{Total proceeds from award}$$

The compensation cost is the grant-date fair value of the award calculated under Topic 718. The average unrecognized compensation cost relates to the period for which the instrument is outstanding, and is calculated as:

$$\frac{\left(\text{Unrecognized compensation cost at beginning of period}^{1} + \text{Unrecognized compensation cost at end of period}^{1}\right)}{2} = \text{Average unrecognized compensation cost}$$

Note:

1. Assumes compensation is recognized ratably, although attribution might not be ratable.

For instruments with no exercise price (unvested stock, RSUs) the proceeds are comprised solely of unrecognized compensation costs.

The treasury stock method is discussed in section 6.9.30.

Example 6.9.35
EPS for share-based payment awards

ABC Corp. has 1,500,000 shares outstanding at January 1, Year 1. ABC institutes its first option plan in Year 1.

On January 1, Year 1, ABC grants 100,000 options with an exercise price equal to the market price of the share at that date ($30). The fair value of each stock option granted is $9 and the options cliff vest at the end of three years.

ABC calculates compensation cost of $900,000 (100,000 × $9) at grant date, to be recognized ratably at $300,000 per year under Topic 718.

The following information is also relevant.

- Net income for Year 1 is $2,500,000.
- ABC's accounting policy is to account for forfeitures when they occur. There were no forfeitures during Year 1.
- The average market price of ABC's shares during Year 1 is $42.
- ABC's tax rate is 21%.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$2,500,000	$2,500,000
Denominator	1,500,000	1,510,714
EPS	$1.67	$1.65

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $2,500,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.

3 Determine basic EPS

Basic EPS = $2,500,000 ÷ 1,500,000 = $1.67

Diluted EPS

1 Identify potential common shares

Options are potential common shares throughout the year because none have vested during the year.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the options are classified as equity (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Number of options (and shares to be issued on exercise of the options)[1]	100,000	(A)
	Exercise price	$30	(B)
	Future services[2]	$750,000	(C)
	Assumed proceeds	**$3,750,000**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$42	(E)
	Number of common shares deemed repurchased	**89,286**	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	100,000	(G)
	Incremental shares	**10,714**	(G) – (F)

Notes:

1. (100,000 options outstanding at beginning of year + 100,000 options outstanding at end of year) ÷ 2 = 100,000 shares assumed issued.
2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense.

Unrecognized compensation cost at beginning of the period:	
Total options outstanding	100,000
Grant-date fair value per option	× $9
Unrecognized compensation cost at beginning of the period	**$900,000**
Annual compensation cost recognized during the year:	
Options estimated to vest	100,000
Grant-date fair value per option	× $9
Total estimated compensation	$900,000
Divide by vesting period	÷ 3 years
Annual compensation cost recognized during the year	**(300,000)**
Compensation cost not recognized on options outstanding at end of the year:	**$600,000**
Average unrecognized compensation during the year[1]	**$750,000**

Note:

1. ((900,000 + 600,000) ÷ 2 = 750,000)

3 Rank the potential common shares

This step does not apply, because the options are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.67 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The stock options are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$2,500,000	1,500,000	$1.67	
Stock options	-	10,714		
Total	**$2,500,000**	**1,510,714**	$1.65	✓

Therefore, ABC includes the effect of the stock options in diluted EPS.

Diluted EPS = $1.65

Question 6.9.65

What is the basis for the average unearned compensation calculation for liability-classified share-based payment awards that are considered equity-classified for EPS?

Interpretive response: Liability-classified share-based payment awards are remeasured at each reporting period, with the remeasurement adjustment recorded as compensation expense. When calculating average unearned compensation as part of the treasury stock method, average unearned compensation is based on the amount that would be recorded had the instrument been classified in equity (i.e. grant-date fair value), and not the remeasured value. See Example 6.9.35.

Question 6.9.70

How are forfeitures of share-based payment awards included in EPS calculations?

Interpretive response: All outstanding share-based payment awards are reflected in the calculation of assumed proceeds from the exercise of the options. Regardless of the entity's accounting policy election for the treatment of forfeitures, the potentially dilutive shares used in the denominator of the diluted EPS calculation are based on the actual number of options or shares granted and not yet forfeited. [260-10-45-29A, 718-10-45-1]

The entity's election regarding forfeitures affects how undistributed earnings are allocated to share-based payment awards when the awards are participating securities (see chapter 5). When an entity has a policy to estimate forfeitures, the effect of the forfeitures on the two-class method calculation for share-based payment awards is summarized in the following table.

	Awards vested (or expected to vest)	**Awards not expected to vest**
Accounting treatment of dividends or dividend equivalents	Retained earnings	Compensation cost
Earnings allocation under two-class method for basic EPS:		
— Distributed earnings	Allocated	Not allocated because already deducted from numerator
— Undistributed earnings	Allocated	Allocated
Denominator to calculate basic EPS for participating award	Weighted-average shares outstanding	Weighted-average shares outstanding

In contrast, if an entity elects to account for forfeitures when they occur, it allocates undistributed earnings to share-based payment awards for which the requisite service is not rendered because of forfeitures during the period. When an entity has elected to recognize forfeitures when they occur, awards forfeited during the period are weighted for the portion of the period the awards were outstanding.

An entity's estimate of the number of awards for which the requisite service is not expected to be rendered – or no estimate, if the entity has elected to account for forfeitures when they occur – for the purpose of determining EPS should be consistent with the estimate used for recognizing compensation cost.

Question 6.9.72

How are redeemable share-based payment awards included in EPS calculations?

Interpretive response: Redeemable share-based payment awards are treated similarly to redeemable common shares – see also Question 3.3.20. The effect on basic EPS depends on whether the instruments are redeemable at fair value.

— **Redeemable at fair value.** No effect. Because the redemption feature is at fair value, it does not represent an economic benefit to the holders that is different from what is received by other shareholders; this is because the shares could be sold on the open market. Therefore, changes in the carrying amount do not represent an in-substance preferential distribution that should be considered when calculating EPS.

— **Redeemable at other than fair value.** The share-based payment awards include an in-substance preferential distribution when the redemption amount is greater than fair value. Increases or decreases in the carrying amount of the redeemable instrument are reflected in the EPS calculation using an approach similar to the two-class method (see section 5.3.10). See also section 6.13 as the EPS effect also depends on whether the instrument is equity- or liability-classified.

If the redemption feature is contingent, there is no numerator adjustment for the period that the redemption feature is not probable (see Question 3.3.22). Once redemption becomes probable, the instrument is treated as a redeemable instrument (i.e. there is a numerator adjustment).

Regardless of whether the redemption is at fair value, the denominator is only affected in diluted EPS. The instruments are included in the EPS denominator using the treasury stock method (and any numerator adjustments are reversed).

Question 6.9.75

Can share-based payment awards be grouped together to determine if they are in-the-money?

Interpretive response: Options and warrants will have a dilutive effect on EPS if they are in-the-money. When considering if options or warrants are in-the-money, each share-based payment award is considered separately. This is consistent with the guidance in Topic 260 that each class of potential common shares is considered separately in calculating diluted EPS. However, awards with the same terms (e.g. exercise price, vesting period) may be considered in the aggregate (see section 4.3). [260-10-45-17]

Question 6.9.78

How are share-based payment awards that are participating securities included in EPS?

Interpretive response: Share-based payment awards that are participating securities are included in basic EPS using the two-class method. For diluted EPS, the more dilutive of the two-class method or the treasury stock method is used. See chapter 5.

Question 6.9.80

If the number of common shares is discretionary under a share-based payment award with a performance condition, when are these potential common shares included in the calculation of diluted EPS?

Interpretive response: If the number of shares awarded is based on the discretion of the compensation committee (or Board of Directors), we believe one acceptable approach is to include potential common shares in the denominator when calculating diluted EPS only after the discretion uncertainty is resolved. This method is consistent with the treatment of contingently issuable shares, which indicates that diluted EPS reflects only those options that would be issued if the end of the reporting period were the end of the contingency period. [260-10-45-48]

Another acceptable approach is to include the potential shares issuable in diluted EPS based on an estimate of probable shares to be issued, provided that the minimum stated threshold for the performance condition is satisfied as of the reporting date. If the minimum threshold is not satisfied, none of the shares should be included in the denominator. This approach is consistent with the recognition of the compensation cost for these shares and the accounting for the potential common shares if they were not subject to an act of discretion by the compensation committee (or Board of Directors).

The accounting policy elected should be consistently applied.

Question 6.9.90

Should unvested shares that vest on satisfaction of a service period or a performance condition be considered outstanding when calculating diluted EPS?

Background: On January 1, Year 6, ABC Corp. grants unvested shares to its employees. The employees will vest in the shares if:

— ABC's basic EPS for the year ending December 31, Year 7 is 20% higher than its basic EPS for the year ended December 31, Year 5; or
— the employee completes three years of service from the date of grant.

ABC's basic EPS for the year ended December 31, Year 6 is 10% higher than its basic EPS for the year ended December 31, Year 5.

Interpretive response: Yes, because the share-based payment awards issued will eventually vest regardless of whether the performance condition is met. As such, the performance condition only serves to potentially accelerate vesting rather than to prevent vesting.

In the background example, even if ABC has not yet met the EPS target, or it does not appear to be on track to meet the EPS target, the employees will be able to vest in the awards if they are still employed on December 31, Year 8. As such, these awards are not considered to be contingently issuable shares, and the awards are considered as outstanding when calculating diluted EPS. In contrast, the awards would be considered contingently issuable if they vest only when both a service period and a performance condition are met.

Using the treasury stock method to calculate diluted EPS

Unvested shares granted to employees are the equivalent of an option or warrant and the dilutive effect of these awards is reflected in diluted EPS by applying the treasury stock method. Therefore, once an entity determines which unvested shares are considered to be outstanding, it calculates their dilutive effect by applying the treasury stock method. It typically will assume a zero exercise price because there is no exercise price to be paid; however, there could be unamortized compensation that should be considered proceeds when applying the treasury stock method. In this scenario, the average unrecognized compensation is based on the three-year attribution period. [260-10-45-22, 45-28A, 45-29]

Question 6.9.93

If an entity records compensation cost for a share-based payment award with a performance condition, are those shares included in diluted EPS?

Interpretive response: Not necessarily. Under Topic 718 (share-based payments) an entity records compensation cost for a share-based payment award with a performance condition when it is probable that the performance condition will be met. Potential common shares that are subject to a performance condition are included in diluted EPS after evaluating the contingency guidance in Topic 260 (see sections 6.10 and 6.11). These shares are included in the diluted EPS calculation only if the contingency would have been met if the end of the reporting period were the end of the contingency period. Therefore, an entity might record compensation cost for an award in the income statement but not include the potential common shares in its diluted EPS calculation. [260-10-45-31, 718-10-25-20]

Example 6.9.40

Unvested common shares – without dividend entitlement

ABC Corp. grants 50,000 unvested common shares to its employees on January 1, March 1 and April 1, Year 1. The shares have different vesting periods and are not entitled to dividends during the vesting period. The transactions are equity-settled share-based payment awards under Topic 718. ABC accounts for forfeitures as they occur.

The grant-date fair value of each of the unvested shares is:

— $6.50 for January 1 (vesting on December 31, Year 1)
— $5.75 for March 1 (vesting on December 31, Year 2)
— $5.00 for April 1 (vesting on December 31, Year 3).

Share-based payment expense recognized under Topic 718 is as follows.

Grant date	Year 1	Year 2	Year 3	Total
Jan 1	$ 325,000	$ –	$ –	$ 325,000
March 1	130,682	156,818	–	287,500
April 1	68,182	90,909	90,909	250,000
Total	$ 523,864	$ 247,727	$ 90,909	$ 862,500

ABC has 3,000,000 common shares outstanding on January 1, Year 2. The average market price per common share in Year 2 is $6. There were no forfeitures of awards during Year 2.

Net income for Year 2 is $4,600,000.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,050,000	3,114,205
EPS	$1.51	$1.48

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

The first grant of shares, vested on December 31, Year 1, is included in the denominator from the beginning of Year 2.

The second grant only vests on December 31, Year 2, and therefore carries a weighting of 0/12 in Year 2.

The third grant, which does not vest until December 31, Year 3 is not included in the basic EPS calculation.

	Number of shares	Time weighting	Weighted average
Common shares outstanding	3,000,000		
Shares vested on Dec. 31, Year 1	50,000		
Jan. – Dec.	3,050,000	12/12	3,050,000
Shares vested on Dec. 31, Year 2	50,000	0/12	0
		12/12	
Weighted average for the year			**3,050,000**

Therefore, the denominator is 3,050,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,050,000 = $1.51

Diluted EPS

1 Identify potential common shares

Unvested common shares are potential common shares throughout the year, because they are treated as the equivalent of options until they are vested.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the unvested shares are classified as equity (see section 6.8).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Future services[1]	$214,773	(A)
	Assumed proceeds	**$214,773**	(B) = (A)
Step ii	Average market price of common shares	$6	(C)
	Number of common shares deemed repurchased	**35,795**	(D) = (B) ÷ (C)
Step iii	Weighted-average potential common shares outstanding[2]	100,000	(E)
	Incremental shares	**64,205**	(E) – (D)

Notes:

1. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense:
   - Unrecognized compensation cost at beginning of year: $156,818 + $90,909 + $90,909 = $338,636
   - Unrecognized compensation cost at end of year: $90,909
   - Average unrecognized compensation cost: $214,773
2. Potential common shares outstanding is the weighted average for the period. [2nd grant (50,000 × 365 ÷ 365) + 3rd grant (50,000 × 365 ÷ 365) = 100,000]

3 Rank the potential common shares

This step does not apply, because the unvested shares are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.51 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The unvested shares are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,050,000	$1.51	
Unvested common shares	-	64,205		
Total	**$4,600,000**	**3,114,205**	$1.48	✓

Therefore, ABC includes the effect of the second and third grants of unvested shares in diluted EPS.

Diluted EPS = $1.48

For an illustration of a situation with dividend entitlement, see Example 6.10.30.

Example 6.9.50

EPS for share-based payment awards – with forfeitures

ABC Corp. has 1,500,000 shares outstanding at January 1, Year 1. ABC institutes its first option plan in Year 1.

On January 1, Year 1, ABC grants 100,000 stock options with an exercise price equal to the market price of the share at that date ($30). The fair value of each stock option granted is $9 and the options cliff vest at the end of three years. ABC's accounting policy is to estimate forfeitures, and it expects that 85,000 of the options granted in Year 1 will vest. Assume a 21% tax rate.

ABC calculates compensation cost of $765,000 (85,000 × $9) at grant date, to be recognized ratably at $255,000 per year pursuant to Topic 718.

The following information is also relevant.

— Net income for the year was $2,500,000.

— During Year 1, 5,000 stock options were forfeited evenly during the year and ABC expects the same amount of forfeitures during each of the next two years.

— The average market price of ABC's shares during Year 1 is $42.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$2,500,000	$2,500,000
Denominator	1,500,000	1,510,357
EPS	$1.67	$1.65

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $2,500,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.

3 Determine basic EPS

Basic EPS = $2,500,000 ÷ 1,500,000 = $1.67

Diluted EPS

1 Identify potential common shares

Stock options are potential common shares throughout the year, because none have vested during the year.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the stock options are classified as equity (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Number of options (and shares to be issued on exercise of the options)[1]	97,500	(A)
	Exercise price	$30	(B)
	Future services[2]	$735,000	(C)
	Assumed proceeds	**$3,660,000**	(D) = ((A) × (B)) + (C)

Step ii	Average market price of common shares	$42	(E)
	Number of common shares deemed repurchased	**87,143**	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	97,500	(G)
	Incremental shares	**10,357**	(G) – (F)

Notes:

1. (100,000 options outstanding at beginning of year + 95,000 options outstanding at end of year) ÷ 2 = 97,500 shares assumed issued.
2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense:

Unrecognized compensation cost at beginning of the period:		
Total options outstanding	100,000	
Grant-date fair value per option	× $9	
Unrecognized compensation cost at beginning of the period		**$900,000**
Annual compensation cost recognized during the year:		
Options estimated to vest	85,000	
Grant-date fair value per option	× $9	
Total estimated compensation	$765,000	
Divide by vesting period	÷ 3 years	
Annual compensation cost recognized during the year		**(255,000)**
Compensation cost not recognized on options outstanding at end of the year:		
Options outstanding (100,000 – 5,000 actual forfeitures)	95,000	
Less: options estimated to vest	(85,000)	
Estimated forfeitures at end of year	10,000	
Grant-date fair value per option	× $9	
	$90,000	
Divide by vesting period	÷ 3 years	
Compensation cost not recognized on options outstanding at end of the year		**(30,000)**
Total compensation cost actually forfeited during the year:		
Actual forfeitures during the year	5,000	
Grant-date fair value per option	× $9	
		(45,000)

Unrecognized compensation cost at year-end[i]	$570,000
Unrecognized compensation cost at beginning of the year	$900,000
Average unrecognized compensation during the year[ii]	**$735,000**

Notes:

i. Unrecognized compensation at year-end is: $900,000 – $255,000 – $30,000 – $45,000. The $570,000 unrecognized compensation cost at year-end can also be calculated as:
   - Expense to be recognized in Years 2 and 3 (after forfeiture assumption):
   - Year 2: 100,000 shares × $9 × 85% ÷ 3 years = $255,000
   - Year 3: 100,000 shares × $9 × 85% ÷ 3 years = $255,000
   - Forfeitures related to Year 2 and 3 less recognized in Year 1: (95,000 – 85,000) × $9 ÷ 3 × 2 = $60,000
   - Unrecognized compensation cost at year-end: $255,000 + 255,000 + 60,000 = $570,000

ii. An alternative way of calculating the average unrecognized compensation cost for Year 1 is: (Unrecognized cost at the beginning of the year (100,000 × $9) + unrecognized cost at the end of the year (95,000 × $9 × 2/3)) ÷ 2 = $735,000.

3 Rank the potential common shares

This step does not apply, because the stock options are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.67 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The stock options are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$2,500,000	1,500,000	$1.67	
Stock options	-	10,357		
Total	**$2,500,000**	**1,510,357**	$1.65	✓

Therefore, ABC includes the effect of the second and third grants of unvested shares in diluted EPS.

Diluted EPS = $1.65

Example 6.9.60

EPS for share-based payment awards – negative (no) incremental shares

Assume the same information as in Example 6.9.50, except that the average market price of ABC Corp. shares during Year 1 is $36.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$2,500,000	$2,500,000
Denominator	1,500,000	1,500,000
EPS	$1.67	$1.67

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $2,500,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.

3 Determine basic EPS

Basic EPS = $2,500,000 ÷ 1,500,000 = $1.67

Diluted EPS

1 Identify potential common shares

Stock options are potential common shares throughout the year, because none have vested during the year.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the stock options are classified as equity (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Number of options (and shares to be issued on exercise of the options)[1]	97,500	(A)
	Exercise price	$30	(B)
	Future services[2]	$735,000	(C)
	Assumed proceeds	**$3,660,000**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$36	(E)
	Number of common shares deemed repurchased	**101,667**	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	97,500	(G)
	Incremental shares	**(4,167)**[3]	(G) – (F)

Notes:

1. (100,000 options outstanding at beginning of year + 95,000 options outstanding at end of year) ÷ 2 = 97,500 shares assumed issued.
2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense – see calculation in Example 6.9.50.
3. Effect on EPS is antidilutive; therefore, options are excluded from weighted-average shares outstanding.

3 Rank the potential common shares

This step does not apply, because the stock options are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.67 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

Applying the treasury stock method results in a negative number of incremental shares. Therefore, the effect is antidilutive. Diluted EPS is the same as basic EPS.

Diluted EPS = $1.67

Question 6.9.94

How is the treasury stock method applied to instruments such as unvested stock and RSUs?

Background: The treasury stock method calculates the number of incremental shares to be included in diluted EPS as the number of shares issuable per the terms of the instrument less shares assumed to be repurchased with the proceeds from the exercise, if there is an exercise. Topic 260 requires the assumed proceeds from exercise of the instrument to be divided by the average market price of the shares during the period to determine the number of shares to be repurchased. [260-10-45-23]

For instruments such as unvested stock or RSUs, there are no assumed proceeds, other than future compensation, if any, in a share-based payment arrangement.

Interpretive response: If there are no proceeds to consider when the treasury stock method is applied to unvested stock and RSUs, the number of incremental shares included is the same as the number of shares issuable per the terms of the instrument. See also sections 6.8 and 6.9.

Example 6.9.70
EPS for RSUs

ABC Corp. has 1,500,000 shares outstanding at January 1, Year 1. ABC institutes its first option plan in Year 1.

On July 1, Year 1, ABC grants 50,000 RSUs. The fair value of each share is $9 and the RSUs cliff vest at the end of three years. ABC's accounting policy is to estimate forfeitures, and it expects that 3% of the RSUs will not vest overall by the end of the three-year period.

ABC calculates compensation cost of $436,500 (50,000 × 97% × $9) at grant date, to be recognized ratably at $145,500 per year under Topic 718.

The following information is also relevant.

— During Year 1, 250 RSUs were forfeited evenly during the period they were outstanding; ABC expects the same amount of forfeitures during the following years.

— The average market price of ABC's shares since the grant date is $8.50.

— The RSUs do not participate in dividends.

— Net income for the year is $2,700,000.

— ABC has a 21% tax rate.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$2,700,000	$2,700,000
Denominator	1,500,000	1,500,000
EPS	$1.80	$1.80

Basic EPS

1 Determine the numerator

No adjustment is necessary as the RSUs do not participate in dividends. The numerator is $2,700,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.

3 Determine basic EPS

Basic EPS = $2,700,000 ÷ 1,500,000 = $1.80

Diluted EPS

1 Identify potential common shares

RSUs are potential common shares from issuance date, because none have vested during the year.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because the RSUs are classified as equity (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Number of RSUs[1]	49,875	(A)
	Exercise price	$0	(B)
	Future services[2]	$411,563	(C)
	Assumed proceeds	**$411,563**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$8.50	(E)
	Number of common shares deemed repurchased	**48,419**	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	49,875	(G)
	Incremental shares	**1,456**	(G) – (F)

Notes:

1. (50,000 RSUs outstanding at beginning of year + 49,750 RSUs outstanding at end of year) ÷ 2 = 49,875 shares issued.
2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This equals the average unearned compensation expense.

Unrecognized compensation cost at beginning of the period:		
Total RSUs	50,000	
Grant-date fair value per RSU	× $9	
		$450,000
Compensation cost recognized during the year:		
RSUs estimated to vest	48,500	
Grant-date fair value per RSU	× $9	
Total estimated compensation	$436,500	
Divide by vesting period	÷ 3 years	
	145,500	
Portion of the year RSUs outstanding	× 6/12	
Less: Compensation cost recognized during the year (for 6/12 of the year)		**($72,750)**
Compensation cost not recognized on RSUs at end of the year:		
Outstanding RSUs (50,000 – 250 actual forfeitures)	49,750	
Less: RSUs estimated to vest	(48,500)	
Estimated forfeitures at end of the year	1,250	
Grant-date fair value per RSU	× $9	
	$11,250	
Divide by vesting period	÷ 3 years	
	3,750	
Portion of the year RSUs outstanding	× 6/12	
Less: compensation cost not recognized on RSUs outstanding at end of the year		**(1,875)**
Total compensation cost actually forfeited during the year:		
Actual forfeitures during the year	250	
Grant-date fair value per RSU	× $9	
		(2,250)
Unrecognized compensation cost at year-end[i]		$373,125

Unrecognized compensation cost at beginning of the year	$450,000
Average unrecognized compensation during the year[ii]	**$411,563**

Note:

i. Unrecognized compensation at year end is: $450,000 – $72,750 – $1,875 – $2,250. The $373,125 unrecognized compensation cost at year-end can also be calculated as:

— Expense to be recognized in Years 2, 3 and 4 (after forfeiture assumption):

– Year 2: 50,000 shares × $9 × 97% ÷ 3 years = $145,500
– Year 3: 50,000 shares × $9 × 97% ÷ 3 years = $145,500
– Year 4: 50,000 shares × $9 × 97% ÷ 3 years × 6/12 = $72,750

— Forfeitures related to Years 2 - 4 less recognized in Year 1: (49,750 – 48,500) × $9 ÷ 3 × 2.5 = $9,375

— Unrecognized compensation cost at year-end: $145,500 + $145,500 + $72,750 + $9,375 = $373,125

ii. An alternative way of calculating the average unrecognized compensation cost for Year 1 is: (Unrecognized cost at the beginning of the year ($450,000) + unrecognized cost at the end of the year (373,125)) ÷ 2 = $411,563.

3 Rank the potential common shares

This step does not apply, because the RSUs are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.80 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The RSUs are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$2,500,000	1,500,000	$1.67	
RSUs	-	1,456		
Total	**$2,500,000**	**1,501,456**	$1.67[1]	✓

Note:

1. The EPS amounts in the table above appear the same because of rounding. The actual per share values are $1.666667 for basic EPS, and $1.66505 for diluted EPS.

Therefore, ABC includes the effect of the RSUs in diluted EPS.

Diluted EPS = $1.67

Question 6.9.95

Are unvested RSUs included in basic EPS?

Interpretive response: No, unvested RSUs are considered contingently returnable and are not included in basic EPS. RSUs are included in basic EPS from the date they are vested. For guidance on contingently returnable and unvested shares see section 6.8.

Question 6.9.100

What is the EPS effect of share-based payment awards related to the former subsidiary and former parent subsequent to a spinoff?

Background: As a result of a spinoff transaction, employees of the former parent (spinnor) may receive unvested equity instruments of the former subsidiary (spinnee), or employees of the former subsidiary may retain unvested equity instruments of the former parent.

Interpretive response: Diluted EPS for the spinnor includes the dilutive effect of all outstanding share-based payment awards. The shares assumed issued on exercise of the share-based payment awards include the potentially dilutive effect from all awards held in the spinnor's shares regardless of whether the awards are held by spinnor or spinnee employees. This is because the awards were granted as a consequence of employment with the spinnor.

However, the calculation of the assumed proceeds from the exercise of awards in the spinnor's treasury stock includes only the average unrecognized compensation cost for the spinnor's awards held by spinnor employees. Unrecognized compensation cost for the spinnee awards held by the spinnor's employees and unrecognized compensation cost for the spinnor awards held by spinnee employees are not included in the assumed proceeds.

The numerator for both basic and diluted EPS calculations includes the compensation cost recognized for awards in spinnor and spinnee held by spinnor employees. There is no adjustment to the numerator to exclude compensation cost recognized by spinnor for spinnee awards held by spinnor's employees.

The following table describes the spinnor's application of the treasury stock method. This guidance also applies from the perspective of the spinnee and the awards held by its employees and spinnor employees. See also Question 6.17.30.

Applying treasury stock method	
Spinnor employees	
Spinnor options	Adjust assumed proceeds for unrecognized compensation cost; compensation cost included in numerator (i.e. compensation cost recognized is not adjusted)

Applying treasury stock method	
SpinCo options	Not reflected in denominator; compensation cost included in numerator (i.e. compensation cost recognized is not adjusted)
SpinCo employees	
Spinnor options	Included in denominator using treasury stock method with no adjustment for unrecognized compensation cost; no impact on numerator (i.e. no compensation cost recognized)
SpinCo options	Not reflected in numerator (i.e. no compensation recognized) nor in denominator

Question 6.9.105
How does a modification of an award affect EPS?

Interpretive response: An entity may change the terms of a share-based payment award, which results in a modification as defined under Topic 718. When there is a modification of a share-based payment award, we believe the entity treats the pre- and post-change awards as two separate awards. This entails two separate treasury stock method calculations: one for the period that the pre-change awards were outstanding, and the other for the period that the post-change awards were outstanding.

Question 6.9.120
What is the EPS effect of the remeasurement of a liability-classified share-based payment award?

Interpretive response: The remeasurement is part of the share-based payment cost recognized in the income statement and therefore already included in earnings. In addition, because the treasury stock method is used for share-based payment awards, there generally is no adjustment to the numerator for the remeasurement under the treasury stock method, unless the share-based payment award is liability-classified for accounting purposes but presumed to be equity-settled for EPS purposes (see section 6.13.20). [260-10-45-29]

Question 6.9.130
How is EPS affected by the early exercise of stock options?

Background: For tax purposes, sometimes, an entity will allow a grantee to exercise a share-based payment award early (i.e. before the award is vested or exercisable). The entity has the ability to repurchase the shares if they ultimately do not vest (i.e. if the goods or services are not provided).

Interpretive response: Shares resulting from the early exercise of stock options are treated similarly to unvested shares for EPS purposes. They are not considered outstanding and therefore not included in basic EPS until all the vesting conditions are met.

For diluted EPS, the treasury stock method is applied, with other conditions for vesting (e.g. performance conditions) being evaluated under the guidance for contingently issuable shares – see section 6.10. When applying the treasury stock method, because there are no future proceeds, as the cash has already been paid as part of the early exercise, the cash received is not included in the calculation of assumed proceeds. See section 6.8 for further discussion on unvested shares. [260-10-45-13, 45-22, 45-28A]

If the instruments are entitled to non-forfeitable dividends, the two-class method is applied to basic EPS, and the more dilutive of the two-class or the treasury stock method is used in diluted EPS. See chapter 5. [260-10-45-61A]

Example 8 in Topic 260 (reproduced below) also illustrates the treasury stock method for share-based payment awards.

Excerpt from ASC 260-10

• > Example 8: Application of the Treasury Stock Method to a Share-Based Payment Arrangement

55-68 This Example illustrates the guidance in paragraph 260-10-45-28A for the application of the treasury stock method when share options are forfeited.

55-69 Entity A adopted a share option plan on January 1, 20X7, and granted 900,000 at-the-money share options with an exercise price of $30. All share options vest at the end of three years (cliff vesting). Entity A's accounting policy is to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-1D or 718-10-35-3. At the grant date, Entity A assumes an annual forfeiture rate of 3 percent and therefore expects to receive the service for 821,406 [900,000 × (.97 to the third power)] share options. On January 1, 20X7, the fair value of each share option granted is $14.69. Grantees forfeited 15,000 stock options ratably during 20X7.

55-69A The average stock price during 20X7 is $44. Net income for the period is $97,385,602. For the year ended December 31, 20X7, there are 25,000,000 weighted-average common shares outstanding. This guidance also applies if the service inception date precedes the grant date.

55-70 The following table illustrates computation of basic and diluted EPS for the year ended December 31, 20X7.

Computation of Basic EPS for the Year Ended December 31, 20X7:

Net income	$ 97,385,602
Weighted-average common shares outstanding	25,000,000
Basic earnings per share	$ 3.90

Computation of assumed proceeds for diluted earnings per share:		
Amount employees would pay if the weighted-average number of options outstanding were exercised using the average exercise price (892,500[b] × $30)		$ 26,775,000
Average unrecognized compensation cost in 20X7 (see computation)		10,944,050
Assumed proceeds		$ 37,719,050
Computation of average unrecognized compensation cost in 20X7:		
Beginning of period		
Unrecognized compensation cost (900,000 × $14.69)		$ 13,221,000
End of the period		
Beginning of the period	$ 13,221,000	
Annual compensation cost recognized during 20X7, based on estimated forfeitures	(4,022,151)[a]	
Annual compensation cost not recognized during the period related to outstanding options at December 31, 20X7, for which the requisite service is not expected to be rendered	(311,399)[c]	
Total compensation cost of actual forfeited options	(220,350)[d]	
Total unrecognized compensation cost, end of the period, based on actual forfeitures		8,667,100
Subtotal		$ 21,888,100
Average total unrecognized compensation, based on actual forfeitures		$ 10,944,050
Assumed repurchase of shares:		
Repurchase shares at average market price during the year ($37,719,050 ÷ $44)		857,251
Incremental shares (892,500 – 857,251)		35,249
Computation of Diluted EPS for the Year Ended December 31, 20X7:		
Net income		$ 97,385,602
Weighted-average common shares outstanding		25,000,000
Incremental shares		35,249
Total shares outstanding		25,035,249
Diluted earnings per share		$ 3.89

a. Pre-tax annual share-based compensation cost is $4,022,151 [(821,406 × $14.69) ÷ 3]
b. Share options granted at the beginning of the year plus share options outstanding at the end of the year divided by two equals the weighted-average number of share

options outstanding in 20X7: [(900,000 ÷ 885,000) ÷ 2] = 892,500. This example assumes that forfeitures occurred ratably throughout 20X7.

c. 885,000 (options outstanding at December 31, 20X7) – 821,406 (options for which the requisite service is expected to be rendered) = 63,594. 63,594 options × $14.69 (grant-date fair value per option) = $934,196 (total fair value). $934,196 ÷ 3 = $311,399 (annual share-based compensation cost).

d. 15,000 (forfeited options) × $14.69 (grant-date fair value per option) = $220,350 (total fair value).

6.9.60 Forward sale contracts

Forward sale contracts are obligations that require the entity to sell its common stock in exchange for cash or other assets. In general, forward sale contracts are included in diluted EPS using the treasury stock method (see sections 4.4.40 and 6.9.30).

Forward sale contracts that are classified as assets or liabilities generally require a numerator adjustment (see section 4.4.30). The adjustment is equivalent to the after-tax fair value adjustment that was recorded during the period.

Forward sale contracts may have different settlement alternatives:

— physically settled (i.e. 'gross settlement', exchange of shares for cash at settlement date);
— net-share settled (out-of-the-money party pays in-the-money party net shares with a value equal to gain at settlement); or
— net-cash settled.

The EPS effect of forward sale contracts depends on both their method of settlement and whether the number of shares to be issued, or the contract price, is fixed or variable.

The following table shows the EPS effect of forward sale contracts indexed to an entity's own common shares. The table assumes that the forward sale contract in question is not a participating security as described in section 5.2. If there are multiple possible forms of settlement, the entity should presume share settlement, if more dilutive, as discussed in section 6.13. [260-10-45-45]

See Question 6.15.30 for guidance on forward purchase contracts.

Type of contract	Basic EPS	Diluted EPS
Equity-classified physically settled forward sale for a fixed number of shares	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method).
Liability-classified physically settled forward sale for a fixed number of shares	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method) considering the numerator adjustment for the after-tax remeasurement gain or loss.

Type of contract	Basic EPS	Diluted EPS
Liability-classified physically settled forward sale for a variable number of shares	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method) considering the numerator adjustment for the after-tax remeasurement gain or loss. Include shares based on contingently issuable shares guidance discussed in section 6.10, if relevant, or guidance on variable denominator discussed in Question 6.15.35.
Liability-classified net share-settled forward sale	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method) considering the numerator adjustment for the after-tax remeasurement gain or loss.
Equity-classified net share-settled forward sale	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method[1]). When this type of forward sale contract is in a gain position, the entity will receive shares upon settlement. Because Topic 260 specifically states that the denominator is increased in diluted EPS, we believe in such scenarios the effect should not be included, because the contract would reduce, not increase, the denominator. [260-10-45-16]
Asset- or liability-classified net cash-settled forward sale	Not considered in basic EPS. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders.	Not considered in calculating diluted EPS because the contract does not allow share settlement. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders.
Equity-classified physically settled prepaid forward sale for a fixed number of shares	Include shares to be issued in basic EPS because shares will be issued for no consideration based only on passage of time. See Question 6.9.150. [260-10-45-13]	No incremental effect – shares are already included in basic EPS. See Question 6.9.150
Equity- or liability-classified physically settled prepaid forward sale contract for variable number of shares	Include minimum number of shares to be issued, if any, in basic EPS because these shares will be issued for no	Apply Topic 260 to determine dilutive effect under the treasury stock method[1]. Include incremental shares, that are not already included in basic EPS, based on relevant guidance on

Type of contract	Basic EPS	Diluted EPS
	consideration based only on the passage of time. See Question 6.9.150. [260-10-45-13]	multiple conversion or exercise bases (in section 4.4.40) or contingent share guidance beginning at paragraph 260-10-45-48 (discussed in section 6.10). See Question 6.9.150[1].

Note:

1. In this scenario there are no future cash proceeds; therefore, the incremental shares under the treasury stock method are determined by number of shares issuable under the contract.

Question 6.9.140

Are all forward sale contracts included in diluted EPS?

Interpretive response: No. Only forward sale contracts that will result in the issuance of shares are included in diluted EPS.

Net-cash settled forward sale contracts

Net-cash settled forward sale contracts are not included in diluted EPS because they will always settle in cash and shares will not be issued.

Forward sale contracts that are physically settled in shares

Forward sale contracts that are physically settled in shares are included in diluted EPS if the effect is dilutive, even if they are out-of-the-money from the holder's perspective (average share price is less than exercise price), in contrast to options and warrants that are not included in diluted EPS when they are out-of-the-money. This is because such forward sale contracts will always be settled by issuance of shares whether they are in-the-money or out-of-the-money, unlike options and warrants.

Forward sale contracts that are net-share settled

Forward sale contracts that are net-share settled are included in diluted EPS only if they are in-the-money from the holder's perspective (average share price is greater than exercise price). Whether the contract is in-the-money must be determined at each reporting period. Net-share settled forward sale contracts that are out-of-the-money from the holder's perspective would result in a reduction of shares when calculating the denominator for diluted EPS. Because Topic 260 specifically states that the denominator is increased in diluted EPS, we believe the effect of net-share settled forward sale contracts that are out-of-the-money from the holder's perspective should not be included, because the contract would reduce, not increase, the denominator. [260-10-45-16]

Observation
Forward sale contracts that are out-of-the-money

A forward sale contract that is uneconomical from the holder's perspective, i.e. out-of-the-money based on the *period-end* price, might still be dilutive and included in diluted EPS if it is physically settled. This is because 'in-the-money' from a Topic 260 perspective is determined by comparing the average share price to the forward contract price. Similarly, the treasury stock method uses the average market price for the year. As long as the average market price is higher than the forward sale contract price, the contract is dilutive, regardless of whether the share price at the end of the reporting period is higher or lower than the forward sale contract price.

Question 6.9.150
How are prepaid forward sale contracts included in basic and diluted EPS?

Interpretive response: Prepaid forward sale contracts are certain to be settled in shares. However, because the purchase price is prepaid, there are no future proceeds to account for in the treasury stock method. In calculating the shares to be included in diluted EPS, instead of calculating the denominator adjustment using the proceeds, the number of shares to be issued under the prepaid forward sale contract is used. How the shares are included in EPS depends on whether they are settled in a fixed or variable number of shares.

— **Fixed prepaid forward sale contracts**. Because the contract price is prepaid for a fixed number of shares, they are treated for EPS purposes as contingently issuable shares issuable for little or no cash or other consideration, subject only to the passage of time. Therefore, because all conditions for their issuance, other than the passage of time, have been met they are included in basic EPS. There is no further effect on diluted EPS, as they are already included in basic EPS. See section 6.10. [250-10-45-13]

— **Variable prepaid forward sale contracts**. There may be a minimum number of shares that is part of the contract terms, when the forward sale contract is prepaid for a variable number of shares. The minimum number of shares feature is similar to a fixed prepaid forward sale contract, and those shares are included in basic EPS, with no additional effect on diluted EPS. An entity evaluates whether the variable shares are to be included in diluted EPS following the guidance on contingently issuable shares and multiple conversion or exercise bases, if relevant (see sections 4.4.40 and 6.10). A numerator adjustment may also be required if the instrument is liability-classified but share-settled (see section 4.4.30). [260-10-45-13, 45-21A]

6.10 Contingently issuable common shares (and common shares subject to recall)

Excerpt from ASC 260-10

• > Treatment of Contingently Issuable Shares in Weighted-Average Shares Outstanding

45-12C Contractual agreements (usually associated with purchase business combinations) sometimes provide for the issuance of additional common shares contingent upon certain conditions being met. Consistent with the objective that basic EPS should represent a measure of the performance of an entity over a specific reporting period, contingently issuable shares should be included in basic EPS only when there is no circumstance under which those shares would not be issued and basic EPS should not be restated for changed circumstances.

45-13 Shares issuable for little or no cash consideration upon the satisfaction of certain conditions (contingently issuable shares) shall be considered outstanding common shares and included in the computation of basic EPS as of the date that all necessary conditions have been satisfied (in essence, when issuance of the shares is no longer contingent). Outstanding common shares that are contingently returnable (that is, subject to recall) shall be treated in the same manner as contingently issuable shares. Thus, contingently issuable shares include shares that meet any of the following criteria:

a. They will be issued in the future upon the satisfaction of specified conditions.
b. They have been placed in escrow and all or part must be returned if specified conditions are not met.
c. They have been issued but the holder must return all or part if specified conditions are not met.

• > Contingently Issuable Shares

45-48 Shares whose issuance is contingent upon the satisfaction of certain conditions shall be considered outstanding and included in the computation of diluted EPS as follows:

a. If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares shall be included as of the beginning of the period in which the conditions were satisfied (or as of the date of the **contingent stock agreement**, if later).
b. If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS shall be based on the number of shares, if any, that would be issuable if the end of the reporting period were the end of the contingency period (for example, the number of shares that would be issuable based on current period earnings or period-end market price) and if the result would be dilutive. Those contingently issuable shares shall be included in the denominator of diluted EPS as of the beginning of the period (or as of the date of the contingent stock agreement, if later).

45-50 Paragraphs 260-10-45-51 through 45-54 provide general guidelines that shall be applied in determining the EPS impact of different types of contingencies that may be included in contingent stock agreements.

45-51 If attainment or maintenance of a specified amount of earnings is the condition and if that amount has been attained, the additional shares shall be considered to be outstanding for the purpose of computing diluted EPS if the effect is dilutive. The diluted EPS computation shall include those shares that would be issued under the conditions of the contract based on the assumption that the current amount of earnings will remain unchanged until the end of the agreement, but only if the effect would be dilutive. Because the amount of earnings may change in a future period, basic EPS shall not include such contingently issuable shares because all necessary conditions have not been satisfied. Example 3 (see paragraph 260-10-55-53) illustrates that provision.

45-52 The number of shares contingently issuable may depend on the market price of the stock at a future date. In that case, computations of diluted EPS shall reflect the number of shares that would be issued based on the current market price at the end of the period being reported on if the effect is dilutive. If the condition is based on an average of market prices over some period of time, the average for that period shall be used. Because the market price may change in a future period, basic EPS shall not include such contingently issuable shares because all necessary conditions have not been satisfied.

45-53 In some cases, the number of shares contingently issuable may depend on both future earnings and future prices of the shares. In that case, the determination of the number of shares included in diluted EPS shall be based on both conditions, that is, earnings to date and current market price—as they exist at the end of each reporting period. If both conditions are not met at the end of the reporting period, no contingently issuable shares shall be included in diluted EPS.

45-54 If the contingency is based on a condition other than earnings or market price (for example, opening a certain number of retail stores), the contingent shares shall be included in the computation of diluted EPS based on the assumption that the current status of the condition will remain unchanged until the end of the contingency period. Example 3 (see paragraph 260-10-55-53) illustrates that provision.

6.10.10 Overview of the instrument

For EPS purposes, contingently issuable common shares are common shares issuable for little or no cash or other consideration, usually on the satisfaction of specified conditions in a contingent share agreement. Common shares that are subject to recall (i.e. contingently returnable) are dealt with in the same way as unvested common shares for EPS purposes. Also, share-based payment awards with a market and/or performance condition are also subject to the guidance on contingently issuable common shares for diluted EPS (and in conjunction with the treasury stock method – see section 6.11). [260-10 Glossary, 260-10-45-12C – 45-13, 45-31]

Contingently issuable common shares include: [260-10-45-13]

— shares to be issued in the future upon the satisfaction of specified conditions;
— shares placed in escrow that must be returned, all or in part, if specified conditions are not met; and
— shares that have been issued but which the holder must return, all or part of, if specified conditions are not met.

These conditions do not include service conditions under Topic 718 and the passage of time. Therefore, shares that are issuable subject only to the passage of time, and unvested shares and options that require only service for vesting, are not considered contingently issuable. A different set of requirements applies to shares that are subject only to a service condition for vesting (see section 6.9). [260-10-45-12C, 45-32]

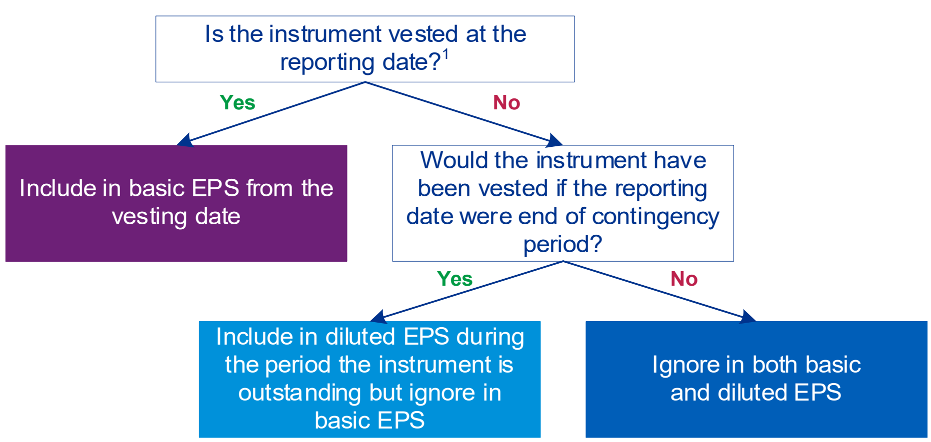
Contingently issuable common shares are typically seen in the context of share-based payment awards with performance conditions, asset acquisitions, or contingent consideration in business combinations. Additional considerations in the context of share-based payment awards are set out in section 6.9. A related class of instruments is contingently issuable potential common shares (see section 6.11).

Warrants exercisable for nominal consideration are discussed in section 3.4.

Prepaid forward sale contracts are also considered contingently issuable shares and are discussed in section 6.9.

6.10.20 EPS implications

Generally, whether contingently issuable common shares are assumed issued and included in the denominator of basic and diluted EPS calculations depends on the extent to which the specified conditions are met at the reporting date. The accounting for these instruments can also have a consequential effect on the numerator – i.e. income available to common shareholders.



Note:

1. See section 6.9 for share-based payment awards EPS considerations, which generally are not treated as contingently issuable shares for basic EPS.

The conditions in the decision tree are tested at the reporting date and do not reflect expectations about the future. This means if the specified conditions would not be met if the reporting date were the end of the contingency period, the contingently issuable common shares are ignored in diluted EPS even if it is probable that the conditions will be met afterwards. This EPS treatment is different from the way in which similar conditions are accounted for under Topic 718 (see section 6.9).

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / Denominator X / ✓	Numerator X / ✓ / Denominator ✓
By definition, contingently issuable common shares are issuable for little or no further consideration on the satisfaction of specified conditions. These are included in basic EPS only when there are no circumstances, other than the passage of time, for which they would not be issued (see section 3.4.30). Even if the condition is met at the end of the reporting period, the status may change by the end of the contingency period. Therefore, they are included in the denominator only from the vesting date – i.e. the date when all conditions are met. This is irrespective of whether the common shares may be issued at a later date. [260-10-45-12C – 45-13, 45-51] If a minimum number of shares will be delivered and all the necessary conditions for their issuance have been satisfied except for the passage of time, that minimum is included in calculating basic EPS. Basic EPS should not be retrospectively adjusted for changed circumstances related to contingently issuable shares. [260-10-45-12 – 45-13]	To the extent that they are not yet taken into account in basic EPS, contingently issuable common shares are potential common shares. The potential adjustment to the numerator depends on the accounting for the contingently issuable common shares under Topic 718 or other relevant Topics. An example of a contingently issuable common share that requires a numerator adjustment is liability-classified contingent consideration in a business combination (see section 6.7). If the effect is dilutive, the number to be included in the denominator is based on the number of common shares that would be issuable if the reporting date were the end of the contingency period. In this case, it is included from the beginning of the period; or from the date of the contingent share agreement, if later. [260-10-45-48]
Dilutive or antidilutive? Generally, the status of the specified conditions at the reporting date determines whether a contingently issuable common share is considered in diluted EPS and whether it is dilutive. However, for contingently issuable common shares that are accounted for as liabilities under Topic 718 or other Topics, the numerator adjustment could vary and therefore could affect whether the instrument is dilutive. [260-10-45-48(b)]	

Observation

Timing difference of compensation cost between basic and diluted EPS

Recognizing compensation cost in the numerator of the diluted EPS calculation may occur before recognition of the related contingent shares in the denominator of that calculation, because of differences in the recognition requirements for the effect of performance awards for each of the elements of the diluted EPS calculation.

Topic 718 requires that accruals of compensation cost for performance awards be recognized if it is probable the performance condition will be achieved. In contrast, Topic 260 requires that diluted EPS reflect only those awards that would be issued if the end of the reporting period were the end of the contingency period. In most cases, performance awards will not be reflected in diluted EPS until the performance condition has been satisfied, even though related compensation cost will be recognized earlier and included in income (the numerator). [260-10-45-31, 718-10-45-1]

6.10.30 Interpretive analysis and examples

How to apply the test for different conditions in a contingent share agreement

Condition	Diluted EPS implication
Earnings target [260-10-45-51] The entity attains the specified amount of earnings or the similar target in a particular reporting period but is also required to maintain the level of earnings for an additional period.	The number of additional shares included, if dilutive, is based on the number of common shares that would be issued if the amount of earnings at the reporting date is the amount of earnings at the end of the contingency period. This assumes that the status of the condition will remain unchanged until the end of the contingency period. How these principles are applied when the contingency relates to attaining an earnings target depends on whether the earnings target is a specified amount or a specified average amount. — **Specified amount.** Attaining or maintaining a specified amount of earnings in the future may be the trigger condition for a contingent share agreement. In this situation, an entity that attains the earnings target by the reporting date considers the additional shares to be outstanding when calculating diluted EPS if the effect is dilutive. When the target is based on attaining a cumulative amount of earnings over several periods, an entity that attains the cumulative earnings target by the reporting date considers the additional shares to be outstanding when calculating diluted EPS if the effect is dilutive. If a target is not met at the end of the reporting period, the entity does not include those shares in

Condition	Diluted EPS implication
	diluted EPS. At each reporting period the earnings amount is reassessed based on current period activity. The diluted EPS calculation includes those shares that the entity issues under the conditions of the contract based on the assumption that the current amount of earnings will remain unchanged until the end of the agreement – i.e. an assumption that there will be no additional earnings and no decrease in earnings in the future. — **Specified average amount.** Contracts that require achievement of a specified average amount of earnings during a period are evaluated in a manner similar to cumulative earnings targets. Shares are not included in diluted EPS calculations until cumulative earnings result in the required average being achieved even if earnings during the remaining periods of evaluation are zero or negative. See Question 6.8.20 for further guidance on applying the earnings target guidance above to multi-year contingencies. See Example 6.10.20 for further guidance on applying the earnings target guidance to cumulative earnings target contingencies.
Market price at a future date [260-10-45-52] Common shares are contingently issuable subject to achieving a specific future market price for the entity's common shares. For example, an option award may contain a condition that the option cannot be exercised until the entity's share price exceeds $30 per share.	The number of additional shares included in the denominator for diluted EPS is based on the number of common shares that would be issued if the market price at the reporting date were the market price at the end of the contingency period. Therefore, diluted EPS reflects the number of shares that would be issued based upon the current market price at the end of the reporting period, if the effect is dilutive. However, contingently convertible debt with a market price trigger is included in diluted EPS regardless of whether the market price trigger has been met. [260-10-45-44]
Both earnings and market price [260-10-45-53] Common shares are contingently issuable subject to achieving and maintaining future earnings and future prices of the common shares.	The number of additional shares included in the denominator for diluted EPS is based on both conditions – i.e. earnings and the market price at the reporting date. Additional shares are not included in the denominator for diluted EPS unless both conditions would be met if the reporting

Condition	Diluted EPS implication
	date were the end of the contingency period (and assuming no future earnings or losses).
Other conditions [260-10-45-54] Common shares are contingently issuable subject to a condition other than earnings or market price – e.g. the opening of a specific number of retail stores.	The additional shares issuable are included in the denominator for diluted EPS based on a condition's status at the reporting date. This assumes that the status of the condition will remain unchanged until the end of the contingency period.

Question 6.10.10

Are share-based payment awards in the form of shares that vest when an employee retires contingently issuable shares?

Interpretive response: Yes. Employee share-based payment awards in the form of shares that vest when an employee retires are treated as contingently issuable shares. These are included in basic EPS from the date the employee reaches retirement eligibility and no longer has to provide future employment to retain the awards. This is the case even though normally shares that are issuable subject only to the passage of time, and unvested shares and options that require only service for vesting, are not considered contingently issuable. This is because there is no service period associated with these awards – the retirement could happen at any time, and upon retirement the awards immediately vest. [260-10-45-48]

Question 6.10.15

Are outstanding shares related to share-based payment awards with contingent clawback features considered common shares subject to recall?

Interpretive response: A clawback feature is a provision in a share-based payment arrangement that requires a grantee in certain situations to return options or shares awarded. Contingent clawback features of a share-based payment award are triggered by a specified event – e.g. restatement of the financial statements or fraudulent behavior of the employee; see paragraph 2.086 in KPMG Handbook, Share-based payment. A contingent clawback feature is accounted for under Topic 718 if and when the underlying contingent event occurs.

As a result, shares outstanding from share-based payment awards with a contingent clawback feature are not considered shares subject to recall. Therefore, shares with a clawback feature are considered outstanding and included in EPS when they meet the requirements in Topic 260, regardless of the share-based payment award clawback feature.

Que/stion 6.10.20

How is EPS affected if a market condition was met at the reporting date, but the share price drops before the financial statements are issued?

Interpretive response: For awards with market conditions, we believe the share price at the reporting date is used as the trigger in calculating diluted EPS for the reporting period even if the share price declines below the trigger level after the reporting date but before the financial statements are issued. However, contingently convertible debt with a market price trigger is included in diluted EPS regardless of whether the market price trigger has been met. [260-10-45-44]

Question 6.10.30

How is previously reported EPS affected if a condition was met at the reporting date but is ultimately not met at the end of the contingency period?

Interpretive response: There is no effect. EPS data previously presented should not be restated if conditions are not met when the contingency period actually expires. The comparative periods still reflect the dilutive effect of the potential common shares as calculated in the previous periods. [260-10-45-12C]

Observation

Basic vs diluted EPS effect of contingently issuable shares whose conditions have been satisfied

Contingently issuable shares are included in basic EPS when the conditions have been satisfied (i.e. vested). In contrast, these same shares are included in diluted EPS from the beginning of the period; or the date from which the contingently issuable shares become outstanding, if later.

Example 6.10.10

Contingency based on average earnings

ABC Corp. has 100,000 common shares outstanding at December 31 of Years 1 to 4. It has no options, warrants or convertible securities outstanding during the period. ABC has a contingent share agreement related to a recent business combination, which provides for the issuance of 1,000 additional shares if the average net income for a four-year period exceeds $250,000.

ABC's consolidated net income (loss) is:

— $150,000 as of December 31, Year 1
— $400,000 as of December 31, Year 2
— $600,000 as of December 31, Year 3
— $(300,000) as of December 31, Year 4.

Diluted EPS denominator calculation

ABC evaluates the effect of the earnings contingency on its diluted EPS denominator as follows.

	Year 1	Year 2	Year 3	Year 4
Consolidated net income (loss)	$150,000	$400,000	$600,000	$(300,000)
Common shares outstanding	100,000	100,000	100,000	100,000
Earnings contingency	–	–[1]	1,000[2]	–[3]
Total shares	**100,000**	**100,000**	**101,000**	**100,000**

Notes:

1. Although the average of the two periods is $275,000, ABC calculates the average assuming no further earnings in Year 3 and Year 4. The average therefore is $137,500 [($150,000 + 400,000 + 0 + 0) ÷ 4].
2. Average of four-year period is $287,500 [($150,000 + $400,000 + 600,000 + 0) ÷ 4]. Therefore, the cumulative earnings threshold would have been met by the end of the period, and the shares are included as of the beginning of the period.
3. Average of four-year period is $212,500, which is below the required earnings.

Question 6.10.40

How is EPS affected by poison pill securities?

Interpretive response: An entity issues poison pill securities to deter hostile takeover attempts by giving existing shareholders the right to receive additional common shares at below market prices if a hostile takeover bid occurs; this would dilute the interests of the bidding company. While poison pill provisions may take a variety of forms, an entity generally excludes these securities from EPS calculations until the triggering event for issuing additional common shares occurs – i.e. until the hostile bid takes place. [260-10-45-57]

Example 6.10.20
Contingently issuable common shares – cumulative earnings

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 2.

On January 1, Year 1, ABC grants 300,000 common shares to its CEO through an equity-settled share-based payment award. The shares will vest at the end of Year 3 if ABC's cumulative earnings for the three years equal or exceed $7,500,000.

Net income for Year 1 is $3,500,000 and for Year 2 is $4,600,000. Therefore, cumulative earnings for the first two years is $8,100,000.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,300,000
EPS	$1.53	$1.39

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary, because contingently issuable common shares are included in the denominator for basic EPS only from the date on which the conditions are met. At the end of Year 2, the cumulative earnings target has not been met because the awards are not vested and may change in the following year – e.g. ABC can have losses in Year 3. Also, there is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The contingently issuable common shares are potential common shares.

Although the cumulative earnings target is not tested until the end of the three-year period, if the end of Year 2 were the end of the contingency period, the target would be met. This is because the cumulative earnings up to the end of Year 2 amount to $8,100,000 (3,500,000 + 4,600,000), which exceeds $7,500,000.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is necessary because the share-based payment is equity-settled (see section 6.8).

Potential adjustment to the denominator for EPIS: The adjustment is based on the number of common shares that would be issued (300,000). This is because the test is applied on what has been achieved at the reporting date. The 300,000 shares are included in the denominator from the beginning of Year 2.

3 Rank the potential common shares

This step does not apply, because the contingently issuable common shares are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The contingently issuable common shares are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Contingently issuable common shares	-	300,000		
Total	**$4,600,000**	**3,300,000**	$1.39	✓

Therefore, ABC includes the effect of the contingently issuable common shares in diluted EPS.

Diluted EPS = $1.39

Observation
Cumulative vs separate contingencies

The answer in Example 6.10.20 would be different if the contingency was based on annual earnings instead of cumulative earnings. If ABC received shares for each year in which earnings met or exceeded $2,500,000, there would be three separate contingencies to evaluate and consider for EPS purposes.

Example 6.10.30
Common shares that are subject to recall – with dividend entitlement

The basic facts are the same as in Example 6.9.50.

The following facts are also relevant for Year 2.

- On January 1, Year 2, ABC issues 300,000 shares to an employee.
- The shares are contingently returnable to ABC if the average market price per common share does not equal or exceed $8.50 for each of Year 2 and Year 3.
- The shares are entitled to non-forfeitable dividends and undistributed earnings while they are subject to recall.
- The grant-date fair value per share subject to recall is $5.75.
- The average market price per common share in Year 2 is $9.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$4,181,818	$4,181,818
Denominator	3,000,000	3,000,000
EPS	$1.39	$1.39

Basic EPS

1 Determine the numerator

Common shares subject to recall are not considered outstanding (see Step 2) – these differ from share-based payment awards with clawback features (see Question 6.10.15).

However, because they are entitled to non-forfeitable dividends, the numerator is adjusted for their participation rights (see section 6.8).

Income available to all shares	$4,600,000
Less income attributable to shares subject to recall [$4,600,000 × 300,000 ÷ (3,000,000 + 300,000)]	(418,182)
Income available to common shareholders	**$4,181,818**

Therefore, the numerator is $4,181,818.

2 Determine the denominator

The common shares issued to the employees are subject to recall throughout the year and are excluded from the denominator. Therefore, the denominator is the weighted-average number of common shares that are not subject to recall: 3,000,000.

3 Determine basic EPS

Basic EPS = $4,181,818 ÷ 3,000,000 = $1.39

Diluted EPS

1 Identify potential common shares

Common shares subject to recall are potential common shares throughout the year. This is because they are treated as the equivalent of options until they are no longer subject to recall.

Although the market price target is not tested until the end of Year 3, if the end of Year 2 were the end of the contingency period, the target would be met. This is because the average market price during Year 2 (the period in which the shares were outstanding), is $9.

2 For each potential common share, calculate EPIS

Potential adjustment to numerator for EPIS: The numerator is adjusted for the income attributable to those shares ($418,182 – see calculation in basic EPS column).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9), as follows.

Step i	Future services[1]	$1,293,750	(A)
	Assumed proceeds	**$1,293,750**	(B) = (A)
Step ii	Average market price of common shares	$9	(C)
	Number of common shares deemed repurchased	**143,750**	(D) = (B) ÷ (C)

Step iii	Number of common shares issued subject to recall	300,000	(E)
	Incremental shares	**156,250**	(E) – (D)

Notes:

1. In this step, proceeds are those from future services to be rendered by the employee for the remaining period not vested.

   This is equal to the average unearned compensation expense:

   - Unrecognized compensation cost at beginning of year: $5.75 × 300,000 = $1,725,000
   - Unrecognized compensation cost at end of year: $5.75 × 300,000 × 1/2 = $862,500
   - Average unrecognized compensation cost: $1,293,750

EPIS is therefore $418,182 ÷156,250 = $2.68

3 Rank the potential common shares

This step does not apply, because shares subject to recall are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.39 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The effect of potentially dilutive instruments is presented as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,181,818	3,000,000	$1.39	
Common shares subject to recall	418,182	156,250		
Total	**$4,600,000**	**3,156,250**	$1.46	✘

To the extent that common shares subject to recall are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

As the common shares subject to recall are entitled to nonforfeitable dividends, they are participating securities, the two-class method applies. In applying the two-class method, basic EPS is calculated similar to as presented above. For diluted EPS, the more dilutive of the two-class method or the treasury stock method is used. See also section 5.7.

Diluted EPS = $1.39

Question 6.10.50
How is EPS affected by share-based payment awards that are forfeited or expire unexercised?

Interpretive response: When share-based payment awards are forfeited or expire unexercised (i.e. the condition was not met), they are removed from the calculation of the diluted EPS denominator from the date they are forfeited or expire. This is regardless of whether the compensation cost is reversed (i.e. for a performance condition that was not met). Further, the numerator is not adjusted for the compensation cost of the forfeited or expired awards, whether or not reversed. See also Question 6.9.70. [260-10-45-29A, 718-10-45-1}

6.11 Contingently issuable potential common shares

Excerpt from ASC 260-10

• > Contingently Issuable Shares

45-55 Contingently issuable potential common shares (other than those covered by a contingent stock agreement, such as contingently issuable convertible securities) shall be included in diluted EPS as follows:

a. An entity shall determine whether the potential common shares may be assumed to be issuable based on the conditions specified for their issuance pursuant to the contingent share provisions in paragraphs 260-10-45-48 through 45-54.
b. If those potential common shares should be reflected in diluted EPS, an entity shall determine their impact on the computation of diluted EPS by following the provisions for options and warrants in paragraphs 260-10-45-22 through 45-37, the provisions for convertible securities in paragraphs 260-10-45-40 through 45-42, and the provisions for contracts that may be settled in stock or cash in paragraph 260-10-45-45, as appropriate.

45-56 Neither interest nor dividends shall be imputed for the additional contingently issuable convertible securities because any imputed amount would be reversed by the if-converted adjustments for assumed conversions.

45-57 However, exercise or conversion shall not be assumed for purposes of computing diluted EPS unless exercise or conversion of similar outstanding potential common shares that are not contingently issuable is assumed. See Example 3 (paragraph 260-10-55-53) for an illustration of this guidance.

6.11.10 Overview of the instrument

Contingently issuable potential common shares are closely related to contingently issuable common shares (see section 6.10). These are potential common shares that are issuable for little or no cash or other consideration on the satisfaction of specified conditions. An example is a contingently issuable convertible instrument. These do not include instruments covered by a contingent share agreement, such as a contingently convertible instrument covered in such an agreement.

The treatment of contingently issuable potential common shares has two parts:

— **Determine if the potential common shares are assumed issuable,** based on the conditions for contingently issuable shares (see section 6.10); and

— **Determine how to include in diluted EPS,** based on the nature of the instrument (options and warrants, convertible instruments, contracts that may be settled in shares or in cash) and the guidance that applies to each type of instrument. These instruments are discussed in the following sections.

Instrument	Section
Options and warrants	6.9
Convertible instruments	6.12
Contracts that may be settled in shares or cash	6.13

6.11.20 EPS implications

By their nature, contingently issuable potential common shares generally do not affect basic EPS. However, these instruments generally do affect diluted EPS and, similar to contingently issuable common shares, their effect depends on the extent to which the specified conditions are met at the reporting date.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X **Denominator X / ✓**	**Numerator X / ✓** **Denominator ✓**
By their nature, contingently issuable potential common shares are generally ignored in basic EPS. This is because, on satisfying the specified conditions, potential common shares (as opposed to common shares) will be issued, and these would not generally result in outstanding common shares until they are exercised or otherwise converted. However, if any options that are contingently issuable can be exercised immediately for little or no further consideration, they are deemed to be exercised and the resulting options are included in the denominator from the vesting date (see section 6.9).	Topic 260 prescribes a two-step approach for determining whether a contingently issuable potential common share is included in diluted EPS. [260-10-45-55] *Step i. Should the contingently issuable potential common share be assumed to be issuable?* This is the same assessment as for contingently issuable common shares (see section 6.10) – i.e. if the reporting date were the end of the contingency period, would the potential common share be issuable? If the instrument passes the test in Step (i), Step (ii) is applied. Convertible debt with a market price trigger is included in diluted EPS, if dilutive, regardless of whether the

Potential effect on basic EPS	Potential effect on diluted EPS
	market price trigger has been met. [260-10-45-44] *Step ii. What is the effect on diluted EPS?* This is different from the requirements for contingently issuable common shares. As opposed to including in the denominator the number of common shares that would be issuable, the effect is determined based on the relevant guidance in Topic 260 for the type of potential common share in question: — for options, warrants and their equivalents, see section 6.9; — for convertible instruments, see section 6.12; and — for contracts that may be settled in common shares or cash, see section 6.13.
Dilutive or antidilutive? Generally, whether a contingently issuable potential common share is dilutive or antidilutive depends on the type of resulting potential common share (see sections 6.9, 6.12 and 6.13). For example, a contingently issuable option is generally dilutive if it is in-the-money – i.e. the exercise price (including the fair value of any goods or services to be supplied to the entity in the future) is lower than the average market price of the common shares.	

6.11.30 Interpretive analysis and examples

Exercise or conversion of the issuable securities should not be assumed when calculating diluted EPS unless exercise or conversion of similar outstanding potential common shares that are not contingently issuable is assumed. [260-10-45-57]

Question 6.11.10

Should interest or dividends be imputed on potential common shares that are assumed issued?

Interpretive response: No. Interest or dividends on the securities assumed to be issued are not imputed because these items would just be reversed when applying the if-converted method. [260-10-45-56]

Example 6.11.10
Contingently issuable potential common shares

ABC has 3,000,000 common shares outstanding on January 1, Year 1 and Year 2.

On January 1, Year 1, ABC grants stock options to its CEO under an equity-settled share-based payment award, conditional on the CEO remaining with ABC for three years. These options will vest at the end of Year 3 if the following performance conditions are met:

— Plan A: 800,000 options subject to a cumulative earnings target of at least $7,500,000 for Year 1–Year 3. The grant-date fair value of the Plan A options is $7.25.

— Plan B: 700,000 options subject to a cumulative increase in revenue of at least 10% at the end of Year 3. The grant-date fair value of the Plan B options is $6.75.

Each option is convertible into one common share, and the exercise price per option under both plans is $31.50. The average market price of ABC's shares is $39 in Year 1 and $43 in Year 2. The following is the revenue change information.

Year	December 31 PY	December 31 CY	Change during year
Year 1	$38,000,000	$44,000,000	+16%
Year 2	$44,000,000	$41,000,000	–7%

ABC has the following net income:

— Year 1: $4,600,000
— Year 2: $3,500,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,033,654
EPS	$1.53	$1.52

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary. This is the case even if the vesting conditions are met, because common shares would not be issued until the vested options are exercised and the options are not issuable for little or no further consideration. Also, there is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The options are potential common shares under both Plan A and Plan B.

Because the options contain performance conditions, they are contingently issuable potential common shares. To determine whether they are included in diluted EPS, the two-step approach is followed.

Step i. Should the contingently issuable potential common shares be assumed to be issuable?

Although the cumulative earnings and revenue targets are not tested until the end of Year 3, if the end of Year 1 were the end of the contingency period:

— the earnings target (for Plan A) would not be met (the cumulative earnings of $4,600,000 are lower than $7,500,000); but

— the revenue target (for Plan B) would be met (16% increase in revenue compared with January 1, Year 1: ($44,000,000 – $38,000,000) ÷ $38,000,000.

Therefore, Plan B passes Step (i).

2 For each potential common share, calculate EPIS

Because only the stock options under Plan B pass the Step (i) test, Step (ii) applies only for these options.

Step ii. What is the effect on diluted EPS?

Because the contingently issuable potential common shares are options, the effect on diluted EPS is determined using the treasury stock method (see section 6.9).

Potential adjustment to the numerator for EPIS: No adjustment is required because the options are equity-settled (see section 6.9.20).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method.

	Plan B		
	Number of options (and shares to be issued on exercise of options)	700,000	(A)
Step i	Exercise price	$31.50	(B)
	Future services[1]	$3,937,500	(C)
	Assumed proceeds	**$25,987,500**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$39	(E)
	Number of common shares deemed repurchased	**666,346**	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	**33,654**	(A) – (F)

Note:

1. In this step, proceeds include the fair value of future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense:
   - Unrecognized compensation cost at beginning of year: 700,000 × $6.75 = $4,725,000 × 3/3 = $4,725,000
   - Unrecognized compensation cost at end of year: $4,725,000 × 2/3 = $3,150,000
   - Average unrecognized compensation cost: ($4,725,000 + $3,150,000) ÷ 2 = $3,937,500

3 Rank the potential common shares

This step does not apply, because the options under Plan B are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The options under Plan B are dilutive because no adjustment to the numerator for EPIS is required and the aggregate amount of the exercise price plus the fair value of future services to be rendered is lower than the average market price of a common share during the period.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares from Plan B		33,654		
Total	**$4,600,000**	**3,033,654**	$1.52	✓

Therefore, ABC includes the effect of Plan B in diluted EPS.

Diluted EPS = $1.52

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$3,500,000	$3,500,000
Denominator	3,000,000	3,146,512
EPS	$1.17	$1.11

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $3,500,000.

2 Determine the denominator

No adjustment is necessary. This is the case even if the vesting conditions are met, because common shares are not issued until the vested options are exercised and the options are not issuable for little or no further consideration. Also, there is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $3,500,000 ÷ 3,000,000 = $1.17

Diluted EPS

1 Identify potential common shares

Options under both Plan A and Plan B are potential common shares.

Because the options contain performance conditions, they are contingently issuable potential common shares. To determine whether they are included in diluted EPS, the two-step approach is followed.

Step i. Should the contingently issuable potential common shares be assumed to be issuable?

Although the cumulative earnings and revenue targets are not tested until the end of Year 3, if the end of Year 2 were the end of the contingency period:

— the earnings target (for Plan A) would be met (the cumulative earnings of $8,100,000 are greater than $7,500,000); but

— the revenue target (for Plan B) would not be met (8% increase in revenue compared with January 1, Year 1: ($41 – $38) ÷ $38.

Therefore, only Plan A passes Step (i).

2 For each potential common share, calculate EPIS

Because only the stock options under Plan A passed the Step (i) test, Step (ii) now applies only for these options.

Step ii. What is the effect on diluted EPS?

Because the contingently issuable potential common shares are options, the effect on diluted EPS is determined using the treasury stock method (see section 6.9).

Potential adjustment to the numerator for EPIS: No adjustment is required because the options are equity-settled (see section 6.9).

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method.

		Plan A	
	Number of options (and shares to be issued on exercise of options)	800,000	(A)
	Exercise price	$31.50	(B)
Step i	Future services[1]	$2,900,000	(C)
	Assumed proceeds	**$28,100,000**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$43	(E)
	Number of common shares deemed repurchased	**653,488**	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	**146,512**	(A) – (F)

Note:

1. In this step, proceeds include the fair value of future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense:
   - Unrecognized compensation cost at beginning of year: 800,000 × $7.25 = $5,800,000 × 2/3 = $3,866,667
   - Unrecognized compensation cost at end of year: $5,800,000 × 1/3 = $1,933,333
   - Average unrecognized compensation cost: ($3,866,667 + $1,933,333) ÷ 2 = $2,900,000

3 Rank the potential common shares

This step does not apply, because the options under Plan A are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.17 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The options under Plan A are dilutive because no adjustment to the numerator for EPIS is required and the aggregate amount of the exercise price plus the fair value of future services to be rendered is lower than the average market price of a common share during the period.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$3,500,000	3,000,000	$1.17	
Incremental shares from Plan A	-	146,512		
Total	**$3,500,000**	**3,146,512**	$1.11	✓

Therefore, ABC includes the effect of Plan A in diluted EPS.

Diluted EPS = $1.11

6.12 Convertible instruments

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Convertible Securities and the If-Converted Method

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.

b. If an entity has convertible debt outstanding:

   1. Interest charges applicable to the convertible debt shall be added back to the numerator. For convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator.
   2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator

shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.

3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).

c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator. See paragraph 260-10-45-21A if the incremental shares are variable (such as when calculating a conversion premium).

45-41 In applying the if-converted method, conversion shall not be assumed for purposes of computing diluted EPS if the effect would be antidilutive. Convertible preferred stock is antidilutive whenever the amount of the dividend declared in or accumulated for the current period per common share obtainable on conversion exceeds basic EPS. Similarly, convertible debt is antidilutive whenever its interest (net of tax and nondiscretionary adjustments) per common share obtainable on conversion exceeds basic EPS.

45-42 Dilutive securities that are issued during a period and dilutive convertible securities for which conversion options lapse, for which preferred stock is redeemed, or for which related debt is extinguished during a period, shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive convertible securities converted during a period shall be included in the denominator for the period prior to actual conversion. The common shares issued upon actual conversion shall be included in the denominator for the period after the date of conversion. Consequently, shares assumed issued shall be weighted for the period the convertible securities were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

• • > Contingently Convertible Instruments

45-43 While the terms of **contingently convertible instruments** vary, a typical instrument includes a market price trigger that exceeds a specified conversion price of the issuer's underlying stock price on the date of issuance by a specified percentage (for example, 10 percent, 20 percent, or 30 percent). Some contingently convertible instruments have floating market price triggers for which conversion is dependent upon the market price of the issuer's stock exceeding the conversion price by a specified percentage or percentages at specified times during the term of the debt. Other contingently convertible instruments require that the market price of the issuer's stock exceed a specified level for a specified period (for example, 20 percent above the conversion price for a 30-day period). In addition, contingently convertible instruments may have additional features such as parity features, issuer call options, and investor put options.

45-44 Contingently convertible instruments shall be included in diluted EPS (if dilutive) regardless of whether the market price trigger has been met. There is no substantive economic difference between contingently convertible instruments and convertible instruments with a market price conversion premium. The treatment for diluted EPS shall not differ because of a contingent market price trigger. The guidance provided in this paragraph also shall be applied to instruments that have multiple contingencies if one of the contingencies is a market price trigger and the instrument is convertible or settleable in shares based on meeting a market condition—that is, the conversion is not dependent (or no longer dependent) on a substantive non-market-based contingency. For example, this guidance applies if an instrument is convertible upon meeting a market price trigger or a substantive non-market-based contingency (for example, a change in control). Alternatively, if the instrument is convertible upon achieving both a market price trigger and a substantive non-market-based contingency, this guidance would not apply until the non-market-based contingency has been met. See Example 11 (paragraph 260-10-55-78) for an illustration of this guidance.

6.12.10 Overview of the instrument

Convertible instruments are instruments other than stand-alone options that by their terms may be converted in whole or in part into the common shares of an entity, such as convertible bonds or convertible preferred shares.

If the conversion option of these instruments is in the scope of Topic 815, the derivative conversion option is recognized at fair value through earnings, or equity component, depending on their terms. For example, a bond with an embedded option to convert it into common shares of the issuer is a hybrid instrument that contains a financial liability and an embedded derivative, if the conversion option is required to be bifurcated from the host and accounted for separately as a derivative. [815-15-25-1]

A convertible instrument may also contain a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date. This instrument is commonly called stock-settled debt. [480-10-25-14(a)]

This section does not address:

- the extinguishment of liabilities with common shares as a result of a renegotiation of the terms of the liabilities (see section 6.5); or
- stand-alone options issued in conjunction with liabilities, such as a bond that is tendered as payment of the exercise price of an option and a bond that is required to be redeemed using proceeds from the exercise of options (see section 6.9).

For further discussion of:

- contracts that contain settlement alternatives, see section 6.13.
- convertible preferred shares, see section 6.14.

6.12.20 EPS implications

Generally, convertible instruments affect only diluted EPS. However, instruments that are mandatorily convertible into common shares can affect basic EPS.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator X / ✓	Numerator ✓ Denominator ✓
Nonmandatorily convertible instruments do not affect basic EPS until they are converted. Generally, common shares issued on the conversion of such convertible instruments are included in the denominator from the date on which the common shares are issuable (see section 3.4.10). Mandatorily convertible instruments are generally included in the denominator from the date on which they are converted because they are not considered to be outstanding common shares until conversion (see Question 3.4.10). A mandatorily convertible instrument may have participation rights, in which case EPS is calculated using the two-class method. [260-10-45-59A – 45-60]	Convertible instruments are potential common shares because they may entitle their holders to an entity's common shares. The potential adjustments to the numerator include the after-tax amount of any dividends or interest, fair value gains or losses (e.g. fair value option, or fair value adjustments for instruments that are otherwise remeasured to fair value) and other consequential changes in income or expense that would result from the assumed conversion. An example of other consequential changes in income or expense' may be the adjustment to depreciation expense if the interest on a convertible instrument has been capitalized into the cost of property, plant and equipment under Subtopic 835-30 (see section 4.4.30). However, a convertible bond for which the principal is required to be paid in cash will not have interest added back to the numerator. The potential adjustment to the denominator is based on the additional common shares resulting from the assumed conversion. Conversion is assumed to have occurred at the beginning of the period; or on the date of issuance of the convertible instrument, if later. [260-10-45-40] Contingently convertible instruments are evaluated to determine if they should be included in the diluted EPS calculation, based on the guidance in section 6.10. Once it is determined that they should be included in diluted EPS, they are included according to the guidance in this section, and using the number of shares/conversion price guidance in section 6.10. Convertible securities (as opposed to other instruments) with a market price contingency are included in diluted EPS regardless of the market price contingency. See also Question 6.12.10.

Dilutive or antidilutive?

Generally, a convertible bond is antidilutive when its after-tax interest (and other consequential changes in income or expense) per common share obtainable on conversion exceeds basic EPS from continuing operations; however, a convertible bond for which principal is required to be paid in cash will not have interest added back to the numerator. Similarly, a convertible preferred share is generally antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per common share obtainable on conversion exceeds basic EPS from continuing operations (see section 6.14). However, because diluted EPS is calculated in sequence, a convertible instrument may be dilutive on its own, yet antidilutive when considered in sequence with other instruments. [260-10-45-40(b), 45-41]

Unlike for options, warrants and their equivalents (see section 6.9), market conditions in a convertible instrument are ignored when calculating diluted EPS. Further, the market price of common shares relative to the conversion price of convertible instruments is irrelevant in deciding whether a particular convertible instrument is dilutive. A convertible instrument may be dilutive even though the embedded conversion option is out-of-the-money. [260-10-45-44]

Dilutive effect of participating securities

Assumed conversion or exercise of many participating securities may be antidilutive because they already receive an allocation of earnings in calculating basic EPS. Therefore, usually they will only be antidilutive if their share of earnings is higher assuming conversion or exercise and this is not offset by the other assumptions inherent in these calculations – e.g. repurchase of common shares with proceeds of exercise for a participating stock option.

However, if the entity has a loss, and the instrument does not participate in the loss, there is no allocation of earnings (losses) in calculating basic EPS. An instrument will generally be antidilutive if the effect of numerator adjustments (for after-tax interest, fair value adjustments) is greater than the effect of the additional shares issuable upon conversion.

6.12.30 Interpretive analysis and examples

Question 6.12.10

Can securities that become convertible in the future be included in diluted EPS if not currently convertible?

Background: Convertible securities include instruments that by their terms may be converted into common shares, such as convertible debt and convertible preferred shares. Convertible securities may be convertible based on the passage of time or the achievement of a defined share price, or they may be convertible in the future based on satisfying certain conditions or a future event.

Interpretive response: It depends. Instruments that become convertible based solely on the passage of time are included in diluted EPS even if not currently convertible. Convertible securities that become convertible in the future based on satisfying certain conditions represent contingently convertible potential common shares. Whether they are included in diluted EPS depends on the nature of the contingency. [260-10-45-55]

— **Securities become convertible based on achieving a defined share price (market price trigger).** Include in diluted EPS using the if-converted method even if they are not currently convertible. When there is a market price trigger in a *convertible* instrument, the contingency is ignored and the instruments are included in diluted EPS regardless; this is different from other instruments with a market price trigger (see sections 6.10.20 and 6.11.20).

— **Securities become convertible based on earnings or other targets (other than market price).** Include in diluted EPS if they would have been included had the reporting date been the end of the contingency period, and assuming no change in the condition (i.e. no further earnings) until the end of the contingency period.

— **Securities become convertible upon the occurrence of a specified event.** Include only when the event occurs.

This contingent share guidance is described more fully in section 6.10.

Question 6.12.20

How is EPS affected by nonmandatorily convertible instruments with conversion terms that are based on the market price of an entity's common shares?

Interpretive response: To determine the exchange ratio for the if-converted method, the entity should use the average market price of the shares for the period. However, if the instruments are considered contingently issuable shares, the contingent share guidance is followed to determine the number of shares to include in the denominator. See Question 6.12.25 and sections 6.10 and 6.11. [260-10-45-21A]

Observation

Contingently convertible instruments vs contingently issuable shares

The contingency in a contingently convertible instrument is evaluated similarly to contingently issuable shares (see section 6.10) except if there is a market price conversion trigger. A market price conversion trigger in a *contingently convertible instrument* is ignored when evaluating if the contingency will be met – i.e. it is assumed to be met regardless of whether the market price conversion trigger has been met. However, when the conversion price varies based on the market price, the guidance for contingently issuable shares subject to a market price at 260-10-45-52 is used to determine the conversion price/number of shares to include in the denominator.

Question 6.12.25

How is EPS calculated for a contingently convertible instrument with variable conversion rates based on the market price?

Interpretive response: A contingently convertible instrument with a market price trigger is treated differently from a contingently issuable share with a similar trigger. A contingently convertible instrument with a market price trigger is included in diluted EPS regardless of whether the market price trigger was met – i.e. the contingency is ignored.

When the market price contingency is ignored, but the instrument's conversion rate or number of shares varies based on the market price, the guidance for contingently issuable shares subject to a market price is used to determine the conversion price/number of shares to include in the denominator. Therefore, the number of shares to include in diluted EPS is determined based on the current market price at the end of the period, if dilutive. An example of the number of shares to be issued or the conversion price varying based on specific market-based criteria is when the holder may convert into 100 shares if the share price at period end is equal to $10, or 120 shares if the share price at period end equals $12).

However, if the conversion rate or number of shares varies based on an average of market prices over a set period of time, the average price for that period is used to determine the conversion price/number of shares to include in diluted EPS. See also sections 6.10 and 6.11. [260-10-45-52]

See also the flowchart at section 4.3 and Question 6.18.60.

Question 6.12.30

How is EPS affected by equity commitment or equity contract notes?

Background: Equity commitment notes and equity contract notes are debt instruments that provide for the issuing entity, generally at its discretion, to repay the debt at maturity using cash proceeds from the issuance of either common shares or preferred shares. An issuing entity repays equity commitment notes with cash proceeds from the sale of either common or preferred shares, whereas equity contract notes obligate the holder to take either common or preferred shares in lieu of cash to repay the debt.

Interpretive response: We believe an entity considers equity contract notes that specifically require the issuance of common shares to repay debt to be potentially dilutive securities and includes them in calculations of diluted EPS using the if-converted method.

Question 6.12.40

How is EPS affected by instruments with more than one conversion feature?

Interpretive response: In some cases, an entity may issue an instrument with more than one conversion feature. This can lead to uncertainty over which conversion feature should be considered when determining the potential common shares for inclusion in the diluted EPS calculation.

For example, convertible bonds may be issued with two conversion features attached to the nonmandatory convertible instruments: an option for early conversion and an option for conversion at the end of a contingent period. The goal in calculating diluted EPS is to determine the maximum potential dilutive effect. Therefore, we believe the entity should separately calculate diluted EPS for the early conversion feature and the conversion at the end of the contingent period to evaluate which feature is most dilutive. The presentation of the diluted EPS is based on the most dilutive scenario. [260-10-45-18]

Question 6.12.50

How is EPS affected by a convertible instrument with a conversion option that is more advantageous to the holder?

Background: A convertible instrument may have a conversion option that permits the holder to pay cash or tender other securities for a more favorable conversion rate.

Interpretive response: When more than one conversion alternative exists, diluted EPS is calculated using the alternative that is most advantageous to the holder. See also Question 6.12.60. [260-10-55-8 – 55-9]

Question 6.12.60

How is EPS affected by a convertible instrument that permits or requires the holder to pay cash at conversion?

Interpretive response: Convertible securities that permit or require the holder to pay cash at conversion are treated as, in substance, warrants. The treasury stock method is used to calculate the denominator, assuming the purchase of common shares for the assumed cash proceeds. However, the if-converted method is also used to adjust the numerator for the effect(s) of the convertible instrument. See also Example 6.12.30. [260-10-55-11]

Example 6.12.10
Convertible debt

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

- On January 1, Year 1, ABC issues 1,000,000 convertible bonds for $1 each. Every 10 bonds are convertible into one common share at the holder's discretion.
- The interest expense for the year relating to the convertible bonds is $100,000. The interest expense is tax-deductible, and the applicable income tax rate is 21%.

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,679,000
Denominator	3,000,000	3,100,000
EPS	$1.53	$1.51

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The convertible bonds are the only potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The full conversion of the bonds would increase income for the year by the after-tax amount of the interest expense[1]:

(interest expense on the convertible bonds) × (1 – income tax rate) = ($100,000) × (1 – 21%) = $79,000

Potential adjustment to the denominator for EPIS: The full conversion of the bonds would increase the number of outstanding shares by 100,000 (1,000,000 ÷ 10).

EPIS is therefore $79,000 ÷ 100,000 = $0.79

Note:

1. When the principal is required to be paid in cash, interest expense is not added back to the numerator.

3 Rank the potential common shares

This step does not apply, because the convertible bonds are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Convertible bonds	79,000	100,000		
Total	**$4,679,000**	**3,100,000**	$1.51	✓

Therefore, ABC includes the effect of the convertible bonds in diluted EPS.

Diluted EPS = $1.51

Example 6.12.20
Contingently convertible debt with a market price trigger

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues contingently convertible debt. The debt holder may convert its debt into common shares when the share price exceeds the market price trigger. The debt holder is entitled only to the par value of the debt if they do not convert the debt.

The following additional facts are relevant.

- The principal amount of the convertible debt is $1,000,000 (1,000 convertible bonds of $1,000 par value each).
- The conversion ratio is 40, with a conversion price of $25 (convertible bond's par value of $1,000 ÷ the conversion ratio of 40).
- The share price of common shares at issuance is $20.
- The average share price for Year 1 is $30.
- The market price trigger provides that the average share price for the year must exceed $33 (130% of the conversion price).
- The interest rate is 4%.
- The effective tax rate is 21%.

Income available to common shareholders for the year ended December 31, Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,631,600
Denominator	3,000,000	3,040,000
EPS	$1.53	$1.52

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary. The denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The contingently convertible debt is the only potential common share.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS[1]: Because this is a convertible instrument, the market price trigger is ignored. The full conversion of the debt would increase income for the year by the after-tax amount of the interest expense[1]:

(interest expense on the convertible bonds) × (1 – income tax rate) = ($40,000) × (1 – 21%) = $31,600

Potential adjustment to the denominator for EPIS: The full conversion of the debt would increase the number of outstanding shares by 40,000 ($1,000,000 ÷ $25).

EPIS is therefore $31,600 ÷ 40,000 = $0.79

Note:

1. When the principal is required to be paid in cash, interest expense is not added back to the numerator.

3 Rank the potential common shares

This step does not apply, because the contingently convertible debt is the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the convertible debt is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Convertible debt	31,600	40,000		
Total	**$4,631,600**	**3,040,000**	$1.52	✓

Therefore, ABC includes the effect of the convertible bonds in diluted EPS.

Diluted EPS = $1.52

ABC includes the dilutive effect of the convertible debt in its diluted EPS even though ABC has not met the market price trigger of $33, because the market price contingency is ignored for convertible instruments with market triggers.

Example 6.12.30
Convertible securities that require cash payment upon conversion

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 1,000,000 convertible bonds for $1 each.

- Every 100 bonds are convertible into one common share at the holder's discretion, and the holder must also pay $5 per share upon conversion.
- The average market price of ABC's common shares during Year 1 is $110.
- The average market price of each bond during Year 1 is $100.

Net income for Year 1 is $4,600,000, which includes interest expense of $100,000 on the bonds. The interest expense is tax deductible and the applicable income tax rate is 21%.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,000,000
EPS	$1.53	$1.53

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The convertible bonds are potential common shares for the period during which they are outstanding. Further, because the terms require the holder to pay cash per share when converting, the convertible securities are treated as warrants, however a numerator adjustment is also made – see step 2.

2 For each potential common share, calculate EPIS

The value of ABC's common shares is greater than the bonds, and therefore it is assumed that bonds will be converted and cash tendered upon conversion (because it is more advantageous for the holder). Therefore, $50,000 [(1,000,000 ÷ 100) × $5] is assumed proceeds in applying the treasury stock method.

Potential adjustment to the numerator for EPIS: The if-converted method is used to account for the conversion of the bond (the impact to the numerator).

Conversion would increase income for the year by the post-tax amount of the interest expense:

> (interest expense on the bonds) × (1 – income tax rate) = ($100,000) × (1 – 21%) = $79,000

Potential adjustment to the denominator for EPIS:

The treasury stock method is used for the impact of the denominator to account for the cash proceeds received. If the bonds were converted without any additional cash paid, the adjustment would be 10,000 shares ($1,000,000 ÷ 100). However, because the holder is also required to pay cash, the convertible instrument is treated as a warrant and the adjustment is determined using the treasury stock method, as follows.

Step i	Number of shares to be issued upon bond conversion	10,000	(A)
	Exercise price	$5	(B)
	Assumed proceeds	**50,000**	(C) = ((A) × (B))
Step ii	Average market price of common shares	$110	(D)
	Number of common shares deemed repurchased	**455**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**9,545**	(A) – (E)

EPIS is therefore $79,000 ÷ 9,545 = $8.28

3 Rank the potential common shares

This step does not apply, because the convertible bonds are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Bond conversion	79,000	9,545		
Total	**$4,679,000**	**3,009,545**	$1.55	✘

To the extent that the convertible bonds are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

Diluted EPS = $1.53

6.12.40 Unit structures

A unit structure is a type of financing transaction that typically involves a unit offering combining debt or convertible preferred shares and a forward contract to issue a variable number of common shares (forward contract). The par value of the debt or preferred shares typically equals the price to be received by the issuer on the forward contract.

This type of transaction may enable an entity to meet its capital needs while offering unique features such as the ability to remarket the underlying debt or preferred shares. Unit structures may be marketed by different financial institutions under the name PRIDES, FELINE PRIDES or DECS. From the holder's perspective the unit structure offers similar benefits to a convertible instrument.

Generally, the forward contract is legally detachable and separately exercisable from the debt or preferred shares. In addition, the debt or preferred shares will be remarketed to other investors at a subsequent date (generally starting three months before the maturity of the forward contract). The intent is to have a successful remarketing that allows the original investor to either use the remarketing proceeds to satisfy the obligation under the forward contract or hold on to the remarketed debt or preferred shares until maturity.

If the remarketing fails, then depending on the terms of the unit structure the investor may have the option to, or may be required to, tender the debt or preferred shares to the issuer to satisfy the forward contract.

Each unit structure has unique terms that the issuer must evaluate to determine the EPS effect of the unit structure. Among the factors to be considered, and which are discussed in this section, are:

- whether the components of the unit structure are participating securities (see Question 6.12.70),
- how diluted EPS is calculated for unit structures with debt instruments (see Question 6.12.80),
- whether changes in the likelihood of a successful remarketing affect diluted EPS (see Question 6.12.90).

The terms of unit structures involving preferred shares could differ significantly from those involving debt instruments. Therefore, significant judgment is necessary based on facts and circumstances to apply the appropriate method to compute diluted EPS.

Question 6.12.70

Are the components of unit structures considered participating securities and, if so, what are the EPS implications?

Interpretive response: It depends. If the forward contract is entitled to participate in earnings with common shares, then it is a participating security. Such participation right may not be explicit and may come in the form of an adjustment to the forward price when dividends on common shares are declared. See section 5.2 for further guidance on identifying participating securities. [260-10-45-63]

If the forward contract is a participating security, the two-class method is applied when calculating basic EPS. We believe an entity calculates diluted EPS using the more dilutive of the two-class method or applicable diluted EPS method (i.e. treasury stock or if-converted, see Question 5.7.10). See chapter 5 for guidance on applying the two-class method. [260-10-45-60A]

Question 6.12.80

How is diluted EPS calculated for unit structures involving a debt instrument?

Background: In a unit structure, if the remarketing is successful, the investor can elect to either:

- retain the debt instrument with the revised interest rate for its remaining term; or
- sell the debt instrument in the remarketing for cash.

In either case, the investor would have to purchase the common shares under the forward contract for cash.

On the other hand, if the remarketing is unsuccessful, the investor can elect to either:

- tender the debt instrument; or
- pay cash in settlement of the forward contract.

In some cases, tendering the debt instrument may be required.

Interpretive response: It depends. Topic 260 presumes that the holder would tender the debt instrument to satisfy the forward contract unless it is more advantageous to the holder to tender cash. [260-10-55-9]

We believe to calculate diluted EPS, the entity must first evaluate the probability of a successful remarketing. If it determines a successful remarketing is probable, it cannot presume the holder will tender the debt instrument (because the option would not be available). Instead, it presumes cash will be tendered, and therefore calculates diluted EPS using the treasury stock method for the forward contract (there is no EPS effect for the debt instrument because it is not convertible, i.e. not a potential common share). [260-10-55-9]

If a successful remarketing is not deemed probable, the entity calculates diluted EPS assuming the holder tenders the debt instrument in settlement of the forward contract. In this case, we believe the if-converted method should be applied to the unit structure in its entirety, with the shares resulting from the forward contract added to the diluted EPS denominator. [260-10-55-9]

If the forward contract is liability-classified (see chapter 6 in KPMG Handbook, Debt and equity financing, for classification guidance), under either method there is an adjustment to the diluted EPS numerator for any remeasurement that was recorded as income or expense during the period (see section 4.4.30 and Question 4.4.40).

Question 6.12.90

Can a change in the likelihood of a successful remarketing affect diluted EPS?

Interpretive response: Yes, when the option of tendering the debt is based on a successful remarketing, we believe an entity should monitor all unit structure transactions to determine whether the likelihood of a successful remarketing is no longer probable. In addition, we believe the likelihood of a successful remarketing will need to be assessed for each unit structure separately because the debt instruments could have different features.

A change in the expected success of a remarketing affects diluted EPS prospectively. For example, a successful remarketing may have initially been deemed probable, and the treasury stock method used to include the forward contract in the diluted EPS calculation. However, if the expectation changes and a successful remarketing is no longer deemed probable and tendering of the debt instrument would then be allowed, the debt instrument would be deemed to have been tendered and the if-converted method would be used to include the forward contract in diluted EPS.

6.13 Contracts that may be settled in shares or in cash

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Contracts That May Be Settled in Stock or Cash

45-45 The effect of potential share settlement shall be included in the diluted EPS calculation (if the effect is more dilutive) for an otherwise cash-settleable instrument that contains a provision that requires or permits share settlement (regardless of whether the election is at the option of the entity or the holder, or the entity has a history or policy of cash settlement). An example of such a contract accounted for in accordance with this paragraph and paragraph 260-10-45-46 is a written call option that gives the holder a choice of settling in common stock or in cash. An election to share settle an instrument, for purposes of applying the guidance in this paragraph, does not include circumstances in which share settlement is contingent upon the occurrence of a specified event or circumstance (such as **contingently issuable shares**). In those circumstances (other than if the contingency is an entity's own share price), the guidance on contingently issuable shares should first be applied, and, if the contingency would be considered met, then the guidance in this paragraph should be applied. Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46, unless the share-based payment arrangement is classified as a liability because of the requirements in paragraph 718-10-25-15 (see paragraph 260-10-45-45A for guidance for those instruments). If the payment of cash is required only upon the final liquidation of an entity, then the entity shall include the effect of potential share settlement in the diluted EPS calculation until the liquidation occurs.

45-45A For a share-based payment arrangement that is classified as a liability because of the requirements in paragraph 718-10-25-15 and may be settled in common stock or in cash at the election of either the entity or the holder, determining whether that contract shall be reflected in the computation of diluted EPS shall be prepared on the basis of the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant guidance of this Topic) if the effect is more dilutive. The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to conclude that the contract will be paid partially or wholly in cash.

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b).

45-47 Paragraphs 260-10-55-32 through 55-36A provide additional guidance on contracts that may be settled in stock or cash.

• > Contracts That May Be Settled in Stock or Cash

55-32 Adjustments shall be made to the numerator for contracts that are asset or liability classified, in accordance with Section 815-40-25, but for which the potential common shares are included in the denominator in accordance with the guidance in 260-10-45-45.For purposes of computing diluted EPS, the adjustments to the numerator are only permitted for instruments for which the effect on net income (the numerator) is different depending on whether the instrument is accounted for as an equity instrument or as an asset or liability (for example, those that are within the scope of Subtopics 480-10 and 815-40).

55-33 The references in paragraphs 260-10-45-30 and 260-10-45-45 for share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee refer to using the guidance in paragraph 260-10-45-45A for purposes of determining whether shares issuable in accordance with such plans are included in the denominator for purposes of computing diluted EPS amounts. Accordingly, the numerator is not adjusted in those circumstances. Paragraph 260-10-55-36A illustrates these requirements.

55-36A The following table illustrates the guidance in paragraphs 260-10-45-45 through 45-46 and 260-10-55-32 through 55-34 for the effects of contracts that may be settled in stock or cash on the computation of diluted EPS.

Assumed Settlement for EPS Purposes [(a)]	Accounting for Book Purposes (per Topic 480 or 815)	Adjustment Required to Book Earnings (Numerator) for Purposes of Computing Diluted Earnings per Share? [(b)]	Adjustment Required to Number of Shares Included in Denominator? [(b)]
Shares	Asset/Liability	Yes (per paragraph 260-10-45-45)	Yes
Shares	Equity	No	Yes
Cash	Asset/Liability	No	No

(a) Note that for purposes of computing EPS, delivery of the full stated amount of cash in exchange for delivery of the full stated number of shares (physical settlement) should be considered share settlement.

(b) Except for forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash. Topic 480 provides EPS guidance for those contracts.

6.13.10 Overview of the instrument

This section discusses contracts that contain settlement alternatives at the issuing entity's or the holder's option. An example of such contracts is a share warrant that can be settled either gross in common shares or net in cash.

Whether such a contract is included in diluted EPS depends on how the instrument is classified and who has the choice of settlement at each reporting date.

If the contract is in the scope of Topic 718 and: [718-10-25-6 – 25-19]

- **the employee has the choice of settlement,** the contract is liability-classified, unless it is a 'combination' award – i.e. award with two or more components in which exercise of one part does not cancel the other(s), which is treated as a compound instrument.
- **the entity has the choice of settlement,** the entity accounts for the award as either liability- or equity-classified in its entirety, with liability classification required if there is a present obligation to settle in cash, or a past practice or stated policy of settling in cash.

If such a contract is in the scope of Topic 815, it may be a derivative, or an equity component, depending on its terms.

The requirements for classifying an instrument as an asset/liability versus equity differ from the requirement to presume share settlement when calculating diluted EPS; and this difference may require adjustments to the numerator and denominator when calculating diluted EPS. For example, a warrant may be liability-classified under Subtopic 815-40 (with changes in fair value recognized in earnings) yet still require a presumption of share settlement under Topic 260.

Convertible instruments under Subtopic 470-20 may impact income available to common shareholders while outstanding and upon conversion. See section 4.4.30 for further discussion on adjustments to the numerator, and chapter 10 of KPMG Handbook, Debt and equity financing, for discussion about the accounting for such instruments.

This section discusses the EPS implications of contracts that may be settled in shares or in cash, including puts and calls on convertible debt. Additional considerations in the context of specific instruments are set out in the following sections:

- instruments under share-based payment awards, see section 6.9; and
- convertible instruments and stock-settled debt, see section 6.12.

6.13.20 EPS implications

Generally, contracts that may be settled in shares or in cash affect only diluted EPS. The effect is ultimately determined with reference to the guidance that applies to the type of potential common share (e.g. option or convertible instrument). The EPS presumption for these contracts (i.e. whether they are assumed converted) can also have a consequential effect on earnings, which affects the numerator in the EPS calculation.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / Denominator X	Numerator X / ✓ / Denominator X / ✓
Contracts that may be settled in shares or in cash are generally ignored because they are not common shares.	Contracts that may be settled in shares or in cash may entitle their holder to common shares, and are therefore potential common shares. Share settlement is presumed (with no option of rebutting the

<table>
<tr><th>Potential effect on basic EPS</th><th>Potential effect on diluted EPS</th></tr>
<tr><td></td><td>presumption), if more dilutive. [260-10-45-45]

For liability-classified share-based payment awards (accounted for under Topic 718), the share-settlement presumption may be rebutted if past experience or a stated policy provides a reasonable basis to conclude that the contract will be paid partly, or wholly, in cash and the entity has demonstrated its intent and ability to do so. [260-10-45-45A]

Under a share-settlement presumption:
— the potential adjustment to the numerator depends on the accounting for the contract under Topic 718 or Topic 815; and
— the potential adjustment to the denominator is determined based on the relevant guidance in Topic 260 for the type of potential common share in question. For example:
– for options, warrants and their equivalents, see section 6.9;
– for contingently issuable common shares and contingently issuable potential common shares, see sections 6.10 and 6.11;
– for convertible instruments, see section 6.12; and
– for written put options and forwards, see section 6.15.</td></tr>
<tr><td colspan="2">Note:
When a conditionally redeemable share becomes mandatorily redeemable under Topic 480, it requires reclassification to a liability. The entity measures the liability upon reclassification initially at fair value and reduces equity by the amount of that fair value, recognizing no gain or loss. Because this reclassification of equity to a liability is like the redemption of shares by issuance of debt, the SEC staff indicated in paragraph 480-10-S99-3A that, similar to the accounting for the redemption of preferred shares in paragraph 260-10-S99-2, to the extent that the fair value of the liability upon reclassification differs from the recorded amount of preferred shares (i.e. recorded in equity or temporary equity), that difference should be deducted from or added to net income available to common shareholders in the calculation of EPS.</td></tr>
</table>

6.13.30 Interpretive analysis and examples#

For contracts that may be settled in shares or in cash, it makes no difference who is given the choice of settlement. Unless the contract is for a liability-classified share-based payment award accounted for under Topic 718, share settlement is presumed, if more dilutive; this means the entity uses the more dilutive method of settlement (either cash or share settlement) to calculate diluted EPS. [260-10-45-45]

For liability-classified share-based payment awards, the presumption that the instrument will be share settled may be overcome if the entity has a past practice or a stated policy, which provides a reasonable basis to conclude that the contract will be paid partly, or wholly, in cash. Each reporting period an entity that asserts cash settlement should review its ability and intent to cash settle. Any changes in the assertion are reflected in EPS on a prospective basis. In addition, an entity should disclose when such a change is made. [260-10-45-45A]

The following table highlights the effect on diluted EPS of different types of convertible debt instruments, as described by the SEC staff, that contain options for the entity (issuer) to settle all or a portion of the obligation in cash. [2003 AICPA Conf]

Convertible debt instrument type and issuer's settlement option	Effect on diluted EPS	Diluted EPS calculation method
Instrument A Issuer must settle the entire obligation in cash upon conversion	No effect (because cash settlement)	N/A
Instrument B Issuer may settle the entire obligation in either shares or cash in an amount equal to the conversion value	Included in diluted EPS. This includes adjustments for both the numerator (e.g. for interest expense) and denominator. [260-10-45-46]	If-converted method
Instrument C Issuer must settle the accreted value in cash and the excess conversion premium (or conversion spread value) may be settled in cash or shares	Conversion premium (conversion spread value) is included in diluted EPS. The numerator is *not* adjusted for interest expense on the instrument. However, a numerator adjustment may be required for mark-to-market adjustments of the conversion premium. [260-10-45-40(b), 45-45]	If-converted method
Instrument X Issuer may settle principal and interest, as well as the conversion premium, in any combination of cash or shares	Included in diluted EPS. This includes adjustments for both the numerator (e.g. for interest expense) and denominator. Therefore, the diluted EPS effect is consistent with Instrument B.	If-converted method

Question 6.13.10#

How is EPS affected when the settlement conclusion for the instrument differs from the accounting treatment?

Interpretive response: The requirements for classifying an instrument as an asset/liability versus equity differ from the requirement to presume share settlement when calculating diluted EPS, and that difference may require an adjustment to the numerator and/or denominator when calculating diluted EPS. For example, a warrant may be liability-classified under Subtopic 815-40 (with changes in fair value recognized in earnings) yet still be treated as share-settled under Topic 260.

The following table summarizes the guidance in paragraphs 260-10-55-32 to 55-36A for the effects of contracts that may be settled in cash or shares on the calculation of diluted EPS.

Assumed settlement for EPS purposes[1, 3]	For accounting purposes	Adjustment required to earnings (numerator) when calculating diluted EPS?[2]	Adjustment required to number of shares included in denominator?[2]
Shares	Asset/Liability	Yes	Yes
Shares	Equity	No	Yes
Cash	Asset/Liability	No	No

Notes:

1. When calculating EPS, delivery of the full stated amount of cash in exchange for delivery of the full stated number of shares (physical settlement) is considered a share settlement.
2. Except for forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash. Topic 480 provides EPS guidance for those contracts
3. ASU 2020-06 removed the ability to rebut the share settlement presumption for all equity-classified instruments, therefore the alternative of cash settlement for EPS purposes and equity-classification for accounting purposes was removed from this table. See Question 6.13A.20.

Question 6.13.15

Is a numerator adjustment made for equity-classified instruments when evaluating if the cash settlement alternative is more dilutive?

Interpretive response: The ability to rebut the share-settlement presumption for equity-classified instruments no longer exists after the adoption of ASU 2020-06 (other than for liability-classified share-based payment awards). Therefore, share settlement is presumed if more dilutive.[260-10-45-45]

While Topic 260 no longer includes guidance for an equity-classified instrument that is presumed cash-settled for EPS purposes, when considering whether cash settlement is more dilutive, a numerator adjustment may be required for the fair value adjustment that would have been made if the instrument had been liability-classified. However, a denominator adjustment is not made under the cash-settlement alternative unless there is a corresponding conversion premium with share settlement.

Example 6.13.03
Convertible bonds that do not require cash payment upon conversion

ABC has 1,000,000 weighted-average common shares outstanding on January 1, Year 2.

On January 1, Year 2, ABC issued $1,000,000 bonds with a par value of $1,000 each convertible into 20 common shares with the option to settle in shares or cash, and no required cash settlement feature for the principal (Instrument X). The conversion feature did not meet the definition of an embedded derivative under Topic 815 and the bonds were not issued at a substantial premium. Therefore, ABC recorded the convertible bonds under a no proceeds allocated model.

The following additional information is relevant for purposes of EPS calculations.

- ABC recorded $40,000 of interest expense for the year.
- The convertible debt is the only potential common share instrument outstanding.
- The net income was $5,000,000.
- ABC's effective tax rate is 21%.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$5,000,000	$5,031,600
Denominator	1,000,000	1,020,000
EPS	$5.00	$4.93

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $5,000,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,000,000.

3 Determine basic EPS

Basic EPS = $5,000,000 ÷ 1,000,000 = $5.00

Diluted EPS

1 Identify potential common shares

The convertible bonds are the only potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The full conversion of the bonds would increase income for the year by the after-tax amount of the interest expense:

(interest expense on the convertible bonds) × (1 – income tax rate) = ($40,000) × (1 – 21%) = $31,600

Potential adjustment to the denominator for EPIS: The full conversion of the bonds would increase the number of outstanding shares 20,000.

EPIS is therefore $31,600 ÷ 20,000 = $1.58

3 Rank the potential common shares

This step does not apply, because the convertible bonds are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $5.00 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$5,000,000	1,000,000	$5.00	
Convertible bonds	31,600	20,000		
Total	**$5,031,600**	**1,020,000**	$4.93	✓

Therefore, ABC includes the effect of the convertible bonds in diluted EPS. Because the cash settlement alternative resulted in no adjustments to the numerator or denominator, the cash settlement alternative equals basic EPS. As a result, the share settlement presumption is more dilutive than the cash settlement alternative.

Diluted EPS = $4.93

Example 6.13.05

Convertible bonds that require cash payment of the principal upon conversion

ABC has 1,000,000 weighted-average common shares outstanding at January 1, Year 2.

On January 1, Year 2, ABC issued $1,000,000 bonds with a par value of $1,000 each convertible into 20 common shares with the option to settle in shares or cash for the conversion spread, and there is a required cash settlement feature for the principal (Instrument C). The conversion feature did not meet the definition of an embedded derivative under Topic 815 and the bonds were not issued at a substantial premium. Therefore, ABC recorded the convertible bonds under a no proceeds allocated model.

The following additional information is relevant for purposes of EPS calculations.

— ABC recorded $40,000 of interest expense for the year.
— The convertible debt is the only potential common share instrument outstanding.
— The net income was $5,000,000.
— The average share price of ABC's common shares was $64 for the year.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$5,000,000	$5,000,000
Denominator	1,000,000	1,004,375
EPS	$5.00	$4.98

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $5,000,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,000,000.

3 Determine basic EPS

Basic EPS = $5,000,000 ÷ 1,000,000 = $5.00

Diluted EPS

1 Identify potential common shares

The convertible bonds are the only potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The full conversion of the bonds would not increase income for the year by the after-tax amount of the interest expense, because the principal is required to be settled in cash.

Potential adjustment to the denominator for EPIS: The full conversion of the bonds would increase the number of outstanding shares by 4,375 (20 shares × 1,000 bonds × $64 per share - $1,000,000 cash principal = $280,000 ÷ $64 average share price).

3 Rank the potential common shares

This step does not apply, because the convertible bonds are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $5.00 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$5,000,000	1,000,000	$5.00	
Convertible bonds	-	4,375		
Total	**$5,000,000**	**1,004,375**	$4.98	✓

ABC calculates diluted EPS under both assumptions to determine which is more dilutive. Because the cash settlement alternative resulted in no adjustments to the numerator and denominator, the cash settlement alternative equals basic EPS. As a result, the share settlement presumption is more dilutive than the cash settlement alternative.

Diluted EPS = $4.98

Example 6.13.08

Convertible bonds that require cash payment for the principal upon conversion with an embedded derivative

ABC has 1,000,000 weighted-average common shares outstanding at January 1, Year 2.

On January 1, Year 2, ABC issued $1,000,000 bonds with a par value of $1,000 each convertible into 20 common shares with the option to settle in shares or cash for the conversion spread, and there is a required cash settlement feature for the principal (Instrument C). The conversion feature meets the definition of an embedded derivative under Topic 815, and therefore ABC recorded the convertible bonds under the embedded derivative model.

The following additional information is relevant for purposes of EPS calculations.

— ABC has 1,000,000 weighted-average common shares outstanding for the year.
— ABC recorded $40,000 of interest expense for the year.
— ABC recorded $20,000 increase in the fair value of the embedded derivative for the year.
— The convertible debt is the only potential common share instrument outstanding.
— The net income was $5,000,000.
— The average share price of ABC's common shares was $64 for the year.
— ABC's effective tax rate is 21%.

ABC presumes share settlement if the effect is more dilutive. ABC calculates diluted EPS under the share-settlement presumption, using the if-converted method, as follows.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$5,000,000	$5,015,800
Denominator	1,000,000	1,004,375
EPS	$5.00	$4.99

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $5,000,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,000,000.

3 Determine basic EPS

Basic EPS = $5,000,000 ÷ 1,000,000 = $5.00

Diluted EPS

1 Identify potential common shares

The convertible bonds are the only potential common shares.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The full conversion of the bonds would increase income for the year by the after-tax amount of the fair value adjustment (but not the interest expense, because the principal is required to be settled in cash):

> (increase in fair value of embedded derivative on the convertible bonds) × (1 – income tax rate) = ($20,000) × (1 – 21%) = $15,800

Potential adjustment to the denominator for EPIS: The full conversion of the bonds would increase the number of outstanding shares by 4,375 (20 shares × 1,000 bonds × $64 per share - $1,000,000 cash principal = $280,000 ÷ $64 average share price).

EPIS is therefore $15,800 ÷ 4,375 = $3.61

3 Rank the potential common shares

This step does not apply, because the convertible bonds are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $5.00 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$5,000,000	1,000,000	$5.00	
Convertible bonds	15,800	4,375		
Total	**$5,015,800**	**1,004,375**	$4.99	✓

ABC calculates diluted EPS under both assumptions to determine which is more dilutive. Because the cash settlement alternative resulted in no adjustments to the numerator or denominator, the cash settlement alternative equals basic EPS. As a result, the share settlement presumption is more dilutive than the cash settlement alternative.

Diluted EPS = $4.99

Question 6.13.20

Are potential common shares associated with liability-classified warrants always included in diluted EPS when the warrants are in-the-money?

Interpretive response: Generally, yes. We believe an entity should include such an instrument in diluted EPS, even when the entity has a net loss, if the effect of the numerator and denominator adjustment is dilutive. This scenario is illustrated in Example 6.13.10.

Example 6.13.10

Potential common shares associated with liability-classified warrants that are in-the-money

ABC Corp. has a net loss of $4,600,000 and 3,000,000 weighted-average common shares outstanding during Year 1.

On January 1, Year 1, ABC issues warrants to investors to buy 50,000 common shares at $10 per share.

- The warrants may be cash-settled at the entity's option.
- The warrants are classified as a liability under Subtopic 815-40.
- The warrants are not participating securities.

ABC records a gain of $150,000 during the year due to changes in the fair value of the warrants. The average market price of ABC's common shares is $20 in Year 1.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$(4,600,000)	$(4,718,500)
Denominator	3,000,000	3,025,000
EPS	$(1.53)	$(1.56)

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $(4,600,000).

2 Determine the denominator

No adjustment is necessary until the warrants are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS (loss per share) = $(4,600,000) ÷ 3,000,000 = $(1.53)

Diluted EPS

1 Identify potential common shares

Warrants are exercisable for more than little consideration and share settlement must be presumed, if more dilutive. The warrants are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

For contracts that may be settled in common shares or cash, the entity presumes share settlement if more dilutive. Therefore, it calculates diluted EPS under both assumptions to determine which is more dilutive.

Cash-settlement assumption

Under this assumption, there is no adjustment to the denominator because cash settlement does not result in any additional common shares being issued. There is also no adjustment to the numerator, because the accounting for the liability at fair value under Subtopic 815-40 is based on the cash alternative – i.e. the cash settlement does not result in consequential changes in earnings.

Further, no adjustment would be made to the numerator as no shares are being added to the denominator.

Share-settlement assumption

Under this assumption, the contract is settled in common shares, and the effect of the liability classification is reversed as a numerator adjustment.

Potential adjustment to the numerator for EPIS: The exercise of the warrants would increase income for the year by the fair value adjustment:

(fair value adjustment) × (1 – income tax rate) = ($150,000) × (1 – 21%) = $118,500

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Number of warrants (and shares to be issued on exercise of warrants)	50,000	(A)
	Exercise price	$10	(B)
	Assumed proceeds	**$500,000**	(C) = ((A) × (B))
Step ii	Average market price of common shares	$20	(D)
	Number of common shares deemed repurchased	**25,000**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**25,000**	(A) – (E)

EPIS is therefore $118,500 ÷ 25,000 = $4.74

3 Rank the potential common shares

This step does not apply, because the warrants are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS (loss per share) is $(1.53) (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$(4,600,000)	3,000,000	$(1.53)	
Exercise of warrants	(118,500)	25,000		
Total	**$(4,718,500)**	**3,025,000**	$(1.56)	✓

The warrants are dilutive, because they increase loss per share as compared to basic EPS.

Share settlement is presumed for diluted EPS, because the share settlement alternative results in a $(1.56) EPS, and therefore it is more dilutive than the cash settlement alternative (which would be the same as basic EPS as there were no numerator or denominator adjustments to EPS when assuming cash settlement).

Diluted EPS = $(1.56)

Observation

Liability-classified warrants under Topic 718 – rebuttable presumption

A rebuttable presumption exists for liability-classified share-based payment awards accounted for under Topic 718 (share-based payments) that may be settled in cash or shares, in that cash settlement can be presumed over share settlement.

When the entity's past practice demonstrates its intent and ability to settle in cash, or there is a stated policy of settling in cash, the presumption of share settlement for diluted EPS may be overcome for these awards. This can happen, for example, when liability-classified warrants are issued as compensation and are therefore in the scope of Topic 718. When cash settlement is presumed, the instruments are not considered potential common shares and there are no diluted EPS implications. The treasury-stock method is not applied because the instrument is not presumed to be converted into shares.

Example 6.13.30

Share-based payment – liability-classified under Topic 718

ABC Corp. has 3,000,000 shares of common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC grants the following share-based payment award to its CEO, conditional on the CEO remaining with ABC for two years. On completion of the service period, the CEO can choose between:

— 1,000,000 stock appreciation rights (SARs) to be settled in cash at the intrinsic value of each SAR (i.e. each SAR requires ABC to pay an amount equal to the appreciation in value of its shares) at the settlement date; or

— 1,000,000 stock options to be settled in ABC's common shares with an exercise price equal to ABC's share price at the grant date ($10).

The share-based payment award is accounted for as a liability-classified award under Topic 718, because the CEO can choose to settle in cash and the value of both options is the same. In addition, this award is not a combination award, because the CEO can choose one or the other settlement option but does not receive both.

The average market price of ABC's common shares during Year 1 is $11. Net income for Year 1 is $4,600,000.

Compensation expense

To calculate the compensation expense for Year 1, ABC determines the following fair values for the individual SAR under Topic 718:

— January 1, Year 1: $1.00
— December 31, Year 1: $1.30.

ABC calculates compensation expense for Year 1 of $650,000 [1,000,000 × $1.30 × 1/2]. The difference between the fair values at grant date and the reporting date is the portion recognized as a remeasurement expense: ($1.30 – $1.00) × 1,000,000 × 1/2 = $150,000. The remeasurement expense is tax-deductible, and the applicable income tax rate is 21%.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,000,000
EPS	$1.53	$1.53

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

The share-based payment award is considered a potential common share, because it may entitle the CEO to ABC's common shares.

2 For each potential common share, calculate EPIS

For contracts that may be settled in common shares or cash, share-settlement is presumed, if more dilutive. This presumption may be rebutted for liability-classified share-based payment awards if the entity has a past history and present intent of settling in cash.

Cash-settlement presumption

Under this presumption, there is no adjustment to the denominator because cash settlement does not result in any additional common shares being issued. There is also no adjustment to the numerator, because the accounting for the liability under Topic 718 is based on the fair value of the cash alternative – i.e. the cash-settlement does not result in consequential changes in earnings.

Share-settlement presumption

Under this presumption, the option can only be settled in common shares.

Potential adjustment to the numerator for EPIS: The options, if they are exercised, would increase earnings for the year by the after-tax amount of the remeasurement expense:

(remeasurement expense on the options) × (1 – income tax rate) =
($150,000) × (1 – 21%) = $118,500

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9) as follows.

Step i	Number of options (and shares to be issued on exercise of options)	1,000,000	(A)
	Exercise price	$10	(B)
	Future services[1]	$750,000	(C)
	Assumed proceeds	**$10,750,000**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$11	(E)
	Number of common shares deemed repurchased	**977,273**	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	**22,727**	(A) – (F)

Note:

1. In this step, proceeds include the fair value of future services to be rendered by the CEO for the remaining period not vested. This is equal to the average unearned compensation expense:
   - Unrecognized compensation cost at beginning of year: 1,000,000 × $1.00 = $1,000,000
   - Unrecognized compensation cost at end of year: $1,000,000 × 1/2 = $500,000
   - Average unrecognized compensation cost: ($1,000,000 + $500,000) ÷ 2 = $750,000

EPIS is therefore $118,500 ÷ 22,727 = $5.21

3 Rank the potential common shares

This step does not apply, because there is only one class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

Under the equity-settlement presumption, the effect of the equity-settlement alternative is presented as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares from stock options	118,500	22,727		
Total	**$4,718,500**	**3,022,727**	$1.56	✘

Because the equity-settlement presumption is not dilutive and the cash-settlement presumption would not result in adjustments to the numerator and denominator, diluted EPS is the same amount as basic EPS.

Diluted EPS = $1.53

Question 6.13.40

Are dividends payable in either cash or shares subject to the guidance on contracts that may be settled in shares or cash?

Interpretive response: No. Dividends that may be paid in cash or shares are not considered contracts that may be settled in shares or cash and are not subject to the guidance on contracts that may be settled in cash or shares in paragraph 260-10-45-45. See Question 3.3.10.

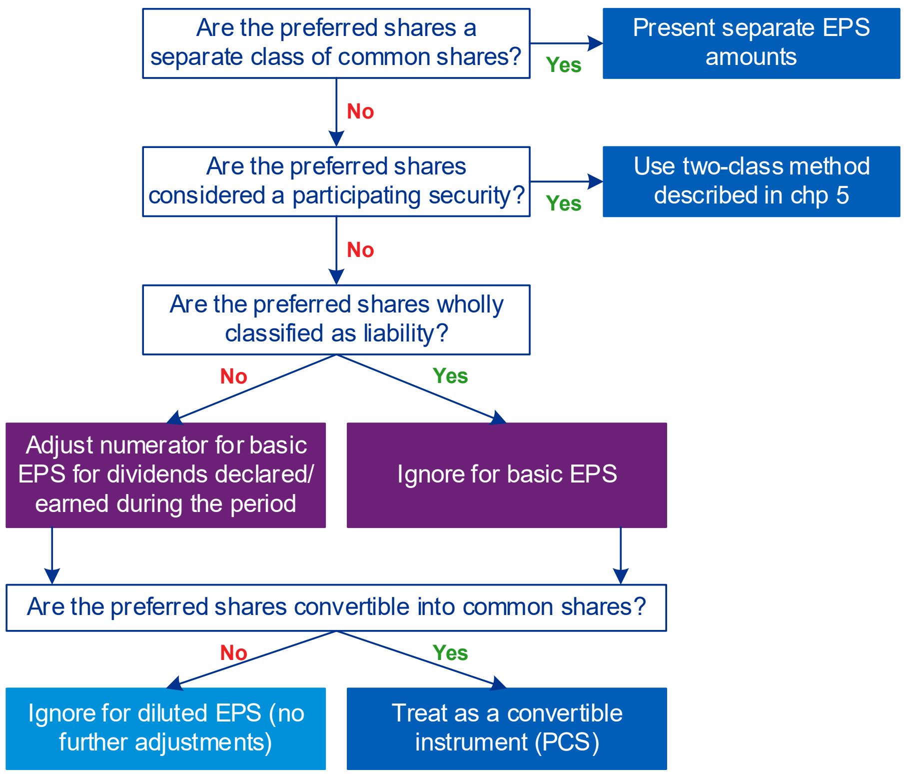
6.14 Preferred shares

6.14.10 Overview of the instrument

Because EPS is presented for each class of common shares, an entity considers whether equity-classified preferred shares are essentially a class of common shares. Common shares of the same 'class' are those shares that have the same right to receive dividends or otherwise share in the profit for the period. Additional considerations for classes of common shares are discussed in section 2.2.20, and the two-class method used to allocated undistributed earnings among the different classes is discussed in chapter 5. [260-10-45-60]

6.14.20 EPS implications

Generally, how preferred shares affect EPS depends on their accounting classification as liabilities or equity instruments, their participation rights and whether they are convertible into common shares.



Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / ✓ **Denominator X**	**Numerator X / ✓** **Denominator X / ✓**
For preferred shares that are wholly or partly classified as equity instruments under Subtopic 505-50 or Topic 815, the numerator is adjusted for any returns to the holders of these shares, which include preferred dividends and any differences arising on settlement. For additional considerations and examples of adjustments for equity-classified preferred shares in basic EPS, see	Preferred shares that are convertible into common shares are potential common shares. For equity-classified convertible preferred shares, the potential adjustment: — to the numerator includes the returns to the holders of these shares adjusted in the calculation of basic EPS; and

Potential effect on basic EPS	Potential effect on diluted EPS
sections 3.3 and 3.4. [260-10-45-11 – 45-12] In addition, separate disclosure of EPS amounts is required for equity-classified preferred shares that form a separate class of common shares. [260-10-45-59A – 45-60] Preferred shares that are wholly classified as liabilities under Topic 480 are not common shares and are excluded from basic EPS. The returns to the holders of these shares (e.g. preference dividends) have generally been recognized in earnings and therefore no further adjustment to the numerator is necessary, but any that have not been recognized in earnings are reversed. [480-10-45-4] Preferred shares classified as temporary equity are considered equity and included in basic EPS. Amounts recognized as dividends under SEC guidance 480-10-S99-3A are adjusted in the numerator. See Question 3.3.20. For preferred shares that are also participating securities (see section 5.2) income attributable to the preferred shares is calculated similar to the adjustments above. The resulting effect on income available to common shareholders for basic EPS is the same.	— to the denominator is based on the additional common shares resulting from the assumed conversion. Conversion is assumed to have occurred at the beginning of the period; or the date of issuance of the convertible preference shares, if later. For an example of adjustments for equity-classified convertible preferred shares in diluted EPS, see section 4.7. [260-10-45-60] For liability-classified convertible preferred shares, the potential adjustment: — to the numerator includes the after-tax amount of any dividends and other consequential changes in income or expense that would result from the assumed conversion; and — to the denominator is based on the additional common shares resulting from the assumed conversion. Conversion is assumed to have occurred at the beginning of the period; or the date of issuance of the convertible preferred shares, if later. For an example of adjustments for convertible instruments containing a liability component, see section 6.12.

Dilutive or antidilutive?

Generally, a convertible preferred share is antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period and any other required adjustment to the numerator per common share obtainable on conversion exceeds basic EPS from continuing operations. However, such a dilutive convertible preferred share can still be antidilutive when considered the sequencing with other instrument in the dilutive EPS calculation. [260-10-45-41]

6.14.30 Interpretive analysis

Question 6.14.10

How is EPS affected when the redemption or induced conversion of convertible preferred shares relates to only a portion of outstanding convertible preferred shares?

Interpretive response: If the redemption or induced conversion (see section 3.3.50) of convertible preferred shares affects only a portion of the previously outstanding convertible preferred shares, any excess consideration on settlement discussed in section 3.3.50 is attributed only to those shares that are redeemed or converted for the purpose of determining whether the remaining outstanding preferred shares are dilutive. Specifically, the instruments are considered separately (those partially converted and those not converted), and no numerator adjustment for this excess consideration is required for the remaining outstanding convertible preferred shares in basic EPS (see Example 3.3.40). [260-10-S99-2]

Question 6.14.20

How is EPS affected by mandatorily convertible preferred shares that are convertible at a predetermined date?

Interpretive response: Preferred shares that are mandatorily convertible into an entity's common shares at a predetermined date typically earn a specified rate of return before conversion (e.g. a fixed-dividend rate). That right to future returns is typically forfeited when the preferred shares are converted.

We believe that if mandatorily convertible preferred shares with a predetermined conversion date have the right to earn a return apart from the right available to common shares, the treatment in diluted EPS of the preferred shares should be no different from the treatment of convertible instruments that are not mandatorily convertible.

In addition, such mandatorily convertible preferred shares are not considered noncontingent securities – e.g. equity warrants issued for little or no consideration (see Question 3.4.10). This is because when converting the preferred shares, the holder forfeits the right to future returns, which represents consideration forfeited. Therefore, these shares do not affect basic EPS, other than for dividends (see section 3.3.20) or if they also have participation rights, in which case the two-class method would be used (see chapter 5).

For diluted EPS, mandatorily convertible preferred shares with a predetermined conversion date are deemed converted, if dilutive, even if the conversion rate is unfavorable to the holders. However, even though mandatorily convertible preferred shares may be converted when the conversion rate is unfavorable, if the effect of the conversion is antidilutive under the if-converted method (see section 4.4), the shares are excluded from the calculation of diluted EPS.

6.15 Written put options and forward purchase contracts

Excerpt from ASC 260-10

• • > Written Put Options and the Reverse Treasury Stock Method

45-35 Contracts that require that the reporting entity repurchase its own stock, such as written put options and forward purchase contracts other than forward purchase contracts accounted for under paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, shall be reflected in the computation of diluted EPS if the effect is dilutive. If those contracts are in the money during the reporting period (the exercise price is above the average market price for that period), the potential dilutive effect on EPS shall be computed using the **reverse treasury stock method**. Under that method:

a. Issuance of sufficient common shares shall be assumed at the beginning of the period (at the average market price during the period) to raise enough proceeds to satisfy the contract.
b. The proceeds from issuance shall be assumed to be used to satisfy the contract (that is, to buy back shares).
c. The incremental shares (the difference between the number of shares assumed issued and the number of shares received from satisfying the contract) shall be included in the denominator of the diluted EPS computation.

45-36 For example, an entity sells 100 put options with an exercise price of $25; the average market price for the period is $20. In computing diluted EPS at the end of the period, the entity assumes it issues 125 shares at $20 per share to satisfy its put obligation of $2,500. The difference between the 125 shares issued and the 100 shares received from satisfying the **put option** (25 incremental shares) would be added to the denominator of diluted EPS.

Excerpt from ASC 480-10

> EPS

45-4 Entities that have issued mandatorily redeemable shares of common stock or entered into forward contracts that require **physical settlement** by repurchase of a fixed number of the **issuer's equity shares** of common stock in exchange for cash shall exclude the common shares that are to be redeemed or repurchased in calculating basic and diluted earnings per share (EPS). Any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to shares that are to be redeemed or repurchased that have not been recognized as interest costs in accordance with paragraph 480-10-35-3 shall be deducted in computing income available to common shareholders (the numerator of the EPS calculation), consistently with the two-class method set forth in paragraphs 260-10-45-60 through 45-70.

6.15.10 Overview of the instruments

Written put options and forward purchase contracts discussed in this section are those that may require an entity to purchase its common shares. A written put option gives the holder the *right* to require the entity to repurchase its shares, and a forward purchase contract *requires* the entity to repurchase its shares. Typically, these instruments are first considered if they fall under the scope of Topic 480 and then under the scope of Subtopic 815-40.

Under Topic 480, a written put option or forward purchase contract that contains an obligation for an entity to purchase its own common shares in cash or other financial assets generally gives rise to a financial liability that is recognized at fair value at inception. Subsequent to initial recognition, the liability is measured under Topic 480.

This section discusses written put options and forward purchase contracts over an entity's own shares.

Written call options and forward contracts that contain an obligation for an entity to sell its own common shares ('forward sale') are not included in this section. These instruments are generally included in diluted EPS using the treasury stock method. See section 6.9 for further discussion on these instruments.

6.15.20 EPS implications

EPS implications for shares that are subject to written put options or forward purchase contracts for an entity to purchase its own shares depend on whether the contract is: [480-10-45-4, 260-10-45-35]

— **A gross physically settled forward purchase contract for an entity to purchase a fixed number of its own shares for cash.** The underlying shares are not regarded as outstanding and are excluded from both basic and diluted EPS, or

— **Written put options or other forward purchase contracts for an entity to purchase its own shares.** These instruments are generally ignored in basic EPS, however, they may affect the number of shares in the denominator of the diluted EPS calculation if they are in-the-money (reverse treasury stock method is applied). Depending on their accounting classification, these instruments may require a numerator adjustment (see section 6.13 and Question 6.15.30).

<table>
<tr><th>Potential effect on basic EPS</th><th>Potential effect on diluted EPS</th></tr>
<tr><td>Numerator X / ✓
Denominator ✓</td><td>Numerator X / ✓
Denominator X / ✓</td></tr>
<tr><td>Common shares subject to forward purchase contracts that require physical settlement by repurchase of a fixed number of common shares in exchange for cash are excluded from the denominator because they are not considered outstanding, similar to unvested shares and shares subject to recall (see section 6.8 and Question 6.15.30). [480-10-45-4]

Common shares subject to written put options or other forward purchase contracts are considered outstanding (i.e. the put or forward is ignored) in basic EPS.

If the common shares underlying the written put options or forward purchase contracts are also entitled to non-forfeitable dividends, such contracts are considered participating securities and basic EPS is calculated using the two-class method, resulting in a numerator adjustment (see section 5.2). [260-10-45-60A, 480-10-45-4]</td><td>Common shares subject to forward purchase contracts that require physical settlement by repurchase of a fixed number of common shares in exchange for cash are excluded from diluted EPS (same approach as basic EPS) (see section 6.8 and Question 6.15.30). [480-10-45-4]

The dilutive effect of common shares subject to written put options or other forward purchase contracts is considered if they are in-the-money (average share price is lower than the exercise price). [260-10-45-35]

Because these are accounted for as financial liabilities, we believe the numerator adjustment for the after-tax remeasurement gain or loss is considered in determining whether the contract is dilutive. However, if an instrument is not in-the-money but yet dilutive when taking into account the numerator adjustment, the dilutive effect of those shares is excluded. [260-10-45-16]

The potential adjustment to the denominator is determined using the reverse treasury stock method. [260-10-45-35]

If the common shares underlying the written put options or forward purchase contracts are entitled to non-forfeitable dividends, such contracts are considered participating securities. We believe that diluted EPS is calculated using the more dilutive of the two-class method or the reverse treasury stock method (see section 5.2 and Question 5.7.10). [260-10-45-60A, 480-10-45-4]</td></tr>
<tr><td colspan="2">Dilutive or antidilutive?

Generally, written puts or forwards are dilutive if they are in-the-money – i.e. the exercise or settlement price is higher than the average market price of the common shares. [260-10-45-35]

However, if these instruments are accounted for as liabilities under Topic 480, the numerator adjustment could vary and could therefore affect whether the instruments are dilutive.</td></tr>
</table>

6.15.30 Reverse treasury stock method

Topic 260 prescribes a specific method, commonly referred to as the 'reverse treasury stock method', for determining the dilutive effect of written put options and forward purchase contracts. This method is similar to the treasury stock method that applies to written calls (see section 6.9), but with an opposite assumption. Instead of assuming that the assumed proceeds from the exercise of options are used to acquire common shares at the average market price (as in the treasury stock method), the reverse treasury stock method assumes that additional common shares are issued to raise enough proceeds to satisfy the exercise or settlement price. The dilutive effect (i.e. the incremental shares) is therefore calculated as the difference between the number of: [260-10-45-35]

- common shares that would have to be issued at the average market price during the period to raise sufficient proceeds to fulfil the written put options or forward purchase contracts; and
- shares that would be repurchased under the terms of the written put options or forward purchase contracts.

The following diagram summarizes the reverse treasury stock method.

The reverse treasury stock method

Step i	**Calculate the proceeds assumed to be raised** Calculate the proceeds that would need to be raised to satisfy the contract.	'Exercise or settlement price' × number of shares subject to written put or forward purchase contracts
Step ii	**Calculate the 'new' shares deemed to have been issued** Calculate the number of common shares that would be issued at the average market price during the period to raise proceeds to satisfy the contract.	Assumed proceeds ÷ Average market price of shares
Step iii	**Determine the incremental shares** Calculate the difference between the number of common shares deemed to have been issued and the number of shares received from buying back the common shares in the contract.	Number of shares deemed to be issued − Number of shares received from satisfying the contract

Consistent with the treasury stock method (see section 6.9), the average market price is determined based on the full reporting period or the period for which the written put options or forward purchase contracts are outstanding if this is shorter. Additional consideration on the average market price is set out in Question 4.4.50.

6.15.40 Interpretive analysis and examples

Question 6.15.10

Is the diluted EPS numerator affected by written put options that require an entity to repurchase its own shares when the options are in-the-money?

Interpretive response: Yes. Because written put options that require an entity to repurchase its own shares will generally be classified as liabilities on the issuer's balance sheet under Topic 480, the numerator of the diluted EPS calculation is adjusted, if the options are in-the-money, for any earnings effects of the contract. This is because the contract is assumed to be satisfied at the beginning of the period or inception of the contract, if later. The earnings effect from marking the put option liability to fair value during the period is removed from the numerator. [480-10-45-4]

Example 6.15.10

Written put options

ABC has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC writes a put option on 200,000 of its common shares.

— The put option has an exercise price of $45.

— ABC recognizes a financial liability for the written put based on fair value. It recognizes an expense for the change in fair value of the liability during Year 1 of $200,000. The applicable income tax rate is 21%.

— The average market price of ABC's common shares during Year 1 is $40.

— Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,600,000
Denominator	3,000,000	3,000,000
EPS	$1.53	$1.53

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

Although the shares subject to the written put option are considered outstanding in basic EPS, the potentially dilutive effect of the written put option is considered in diluted EPS, because the written put option is in-the-money from the holder's perspective.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: Because the assumed exercise of the written put option occurred at the beginning of the year, the numerator increases by the change in fair value recognized for the written put option during the year, calculated as follows.

> (fair value change for the written put liability) × (1 – income tax rate) = ($200,000) × (1 – 21%) = $158,000

Potential adjustment to the denominator for EPIS: The adjustment is determined using the reverse treasury stock method, as follows.

Step i	Number of options (and shares to be received to satisfy contract)	200,000	(A)
	Exercise price	$45	(B)
	Proceeds assumed to be raised	**$9,000,000**	(C) = (A) × (B)

	Average market price of common shares	$40	(D)
Step ii	**Number of common shares deemed issued**	**225,000**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**25,000**	(E) – (A)

Therefore, EPIS is $158,000 ÷ 25,000 = $6.32

3 Rank the potential common shares

This step does not apply, because the written put option is the only potentially dilutive instrument.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the written put option is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares from written put option	158,000	25,000		
Total	**$4,758,000**	**3,025,000**	$1.57	✘

Because the effect is antidilutive, ABC does not include the effect of the written put option in diluted EPS.

Diluted EPS = $1.53

Question 6.15.20

How is EPS affected by dividends on a liability-classified physically settled forward purchase contract or mandatorily redeemable financial instrument?

Background: Shares underlying physically settled forward purchase contracts for a fixed number of shares and mandatorily redeemable financial instruments that are liability-classified are excluded from basic and diluted EPS. [480-10-45-4]

Interpretive response: For physically settled forward purchase contracts for a fixed number of shares and mandatorily redeemable financial instruments that are liability-classified, dividends are recognized in earnings as interest costs during the life of the contract and there is no need to adjust the basic and diluted EPS numerator for distributed earnings related to these dividends. However, an adjustment may be necessary for future dividends (i.e. undistributed earnings) relating to forward contracts depending on whether the dividends revert back to the issuer – i.e. whether the holders of the shares underlying the forward purchase contract are entitled to any dividends that are declared on those shares during the instrument's term.

- **Declared dividends revert back to the issuer.** No further numerator adjustment is necessary, because the undistributed earnings in respect of the shares underlying the instrument are available for distribution to common shareholders.
- **Declared dividends do not revert back to the issuer.** A further adjustment to the numerator is necessary for the undistributed earnings as the undistributed earnings are not available to the common shareholders, and therefore the two-class method of calculating EPS is applied (see chapter 5).

See Example 6.15.20.

Question 6.15.30

How is EPS affected by forward purchase contracts indexed to an entity's own common shares?

Interpretive response: Forward purchase contracts indexed to an entity's own shares may take many forms. For example, those contracts may be:

- physically settled (i.e. 'gross settlement' exchange of shares for cash at settlement date);
- net-share settled (out-of-the-money party pays in-the-money party net shares with a value equal to gain at settlement); or
- net-cash settled.

They also may provide alternative settlement options to one of the parties to the arrangement.

The accounting considerations for forward purchase contracts and other share-indexed derivatives (such as options) can be complex. An entity may classify these contracts as liabilities or as equity under Topic 480, Topic 815 and other Topics, and in some cases the contracts may be in an asset position. See chapters 2, 6 and 8 of KPMG Handbook, Debt and equity financing. In addition, where there is a choice of cash or share settlement, the accounting treatment of a contract indexed to an entity's own shares may not correspond to its treatment in diluted EPS calculations. For example, the contract may be liability-classified, yet share settlement is presumed. When this is the case, a numerator adjustment may be necessary for the difference between the way the contract is recorded and the way it would be recorded if the accounting treatment was the same as the presumed EPS treatment (see section 6.13).

Topic 480 applies to both the accounting and EPS treatment for physically settled forward purchase contracts. For other types of forward purchase contracts, Topic 260 applies to the EPS treatment – e.g. the reverse treasury stock method, guidance on contingently issuable shares, guidance on contracts settleable in cash or shares.

The following table shows the EPS effect of forward purchase contracts indexed to an entity's own common shares. The table assumes that the forward purchase contract in question is not a participating security, as described in section 5.2. If there are multiple possible forms of settlement, consider the guidance in section 6.13 to determine which method of settlement to use when calculating EPS. For purposes of the examples in this table share settlement is presumed.

For an illustration of the EPS effects of dividends on the shares underlying a forward purchase contract, see Example 6.15.20.

See section 6.9.50 for guidance on forward sale contracts.

Type of contract	Basic EPS	Diluted EPS
Liability-classified physically settled forward purchase for a fixed number of shares[1]	Exclude shares to be repurchased from basic EPS per Topic 480. See Example 6.15.20. [480-10-45-4]	No incremental effect because shares are already reduced from the denominator for basic EPS.
Liability-classified physically settled forward purchase for a variable number of shares	Topic 480 applies only to a liability-classified physically settled forward purchase contract for a fixed number of shares. Some forward purchase contracts for a variable number of shares may specify a minimum number of shares to be repurchased. By analogy to the guidance in paragraph 480-10-45-4, exclude the contractual minimum number of shares to be repurchased from basic EPS.	The minimum number of shares to be repurchased is already reduced from the denominator for basic EPS and has no incremental effect on diluted EPS. If there is no minimum number of shares to repurchase or for variable shares above the minimum to be repurchased, apply Topic 260 to determine the dilutive effect of variable shares under the reverse treasury stock method (include shares based on contingently issuable shares guidance discussed in section 6.10, if relevant, or guidance on variable denominator discussed in Question 6.15.35).
Asset-classified net share-settled forward purchase (under paragraph 480-10-25-14)	Not considered in basic EPS. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders.	As Topic 260 specifically states that the denominator is increased in diluted EPS, we believe the effect of asset-classified forward purchase contracts should not be included even if the numerator adjustment would result in a smaller numerator (and the overall effect could be dilutive), because the contract would reduce, not increase, the denominator. [260-10-45-16]

Type of contract	Basic EPS	Diluted EPS
Liability-classified net share-settled forward purchase (under paragraph 480-10-25-14)	Not considered in basic EPS. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders	Apply Topic 260 to determine dilutive effect (use reverse treasury stock method – see Question 6.15.38), considering the numerator adjustment for the after-tax remeasurement gain or loss.
Asset- or liability-classified net cash-settled forward purchase	Not considered in basic EPS. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders.	Not considered in calculating diluted EPS because the contract does not allow share settlement. The numerator should not be adjusted to exclude the effect of the contract on income available to common shareholders.
Equity-classified physically settled prepaid forward purchase for a fixed number of shares[2]	By analogy to Topic 480's guidance on liability-classified contracts, shares to be repurchased are excluded from basic EPS.	By analogy to Topic 480's guidance on liability-classified contracts, shares to be repurchased are excluded from basic EPS, therefore there is no incremental diluted EPS effect.
Equity-classified physically settled prepaid forward purchase for a variable number of shares[3]	Not considered in basic EPS, unless a minimum number of shares to be repurchased is stipulated in the contract, in which case the minimum number of shares is excluded from basic EPS.	Because the contract is prepaid, the entity would not need to issue additional shares to fund the purchase price under the reverse treasury stock method. Further, Topic 260 specifically states that the denominator is increased in diluted EPS, therefore we believe the effect of equity-classified prepaid forward purchase contracts should not be included, because the contract would reduce, not increase, the denominator. [260-10-45-16]

Notes:

1. The number of outstanding shares associated with liability-classified physically settled forward purchase contracts measured at the present value of the contract amount is removed from the denominator in calculating basic and diluted EPS in the same way as required for mandatorily redeemable shares classified as liabilities. This is because the accounting for physically settled forward purchase contracts reduces equity; even though the shares are still outstanding, and they are accounted for as if effectively retired.
2. Although a physically settled prepaid forward contract to repurchase a fixed number of an issuer's equity shares is accounted for as a single instrument, it can be viewed as two separate components. The first component is a forward contract to repurchase a fixed number of an entity's own shares with physical delivery as the only settlement alternative. The second component is a loan receivable. We believe the EPS treatment for a liability-classified physically

settled forward purchase contract for a fixed number of shares should be applied by analogy because the first component can be viewed as such an instrument.

However, in some cases, the contract is executed concurrently with the issuance of one or more additional financial instruments. If a physically settled prepaid forward purchase contract is required to be accounted for on a combined basis with another financial instrument, it may not be appropriate to exclude the shares underlying the prepaid forward purchase contract from the denominator in the calculation of basic and diluted EPS; in that case, further consideration may be needed to determine the overall basic and diluted EPS effect.

3. Because the prepaid forward purchase contract does not require settlement in a fixed number of the issuer's equity shares, the EPS guidance in Topic 480 related to forward purchase contracts that require physical settlement by repurchase of a fixed number of the issuer's common shares in exchange for cash is not applied by analogy. However, because the contract is prepaid, if there is a minimum number of shares to be repurchased, this amount should be excluded.

Example 6.15.20

Dividends on the underlying shares and effect on EPS during the period of the forward purchase contract

ABC Corp. has 10,000 common shares outstanding during Year 2 and has net income of $115,000. It has no outstanding securities or contracts that may entitle the holder to obtain common shares. In Year 1, ABC had entered into a forward purchase contract on 1,000 of its common shares that will be settled in two years for a price of $20 per share. The forward contract requires physical settlement in cash, for a fixed number of shares.

During Year 2, ABC recognizes $1,000 of interest cost related to the forward contract under Topic 480, which is accreted at the rate implicit at inception of the contract.

The following information is also relevant.

- The weighted-average price of ABC's shares during Year 2 is $12.50 per share (this was also the weighted-average share price during each interim period of Year 2).
- ABC does not declare dividends on its common shares during Year 2.

Scenario 1: Dividends underlying the forward contract revert back to ABC

In this scenario, any dividends declared on the shares underlying the forward contract revert back to ABC as per the contractual terms of the forward contract. ABC determines that the forward contract is in the scope of Topic 480.

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$115,000	$115,000
Denominator	9,000	9,000
EPS	$12.78	$12.78

Basic EPS

1 Determine the numerator

No adjustment is necessary because dividends underlying the forward contract revert back to ABC. Therefore, the two-class method is not applied (see chapter 5) and the numerator is $115,000.

2 Determine the denominator

The shares to be repurchased upon settlement of the forward contract are excluded from the denominator of basic EPS.

	Number of shares	Time weighting	Weighted average
Jan. – Dec.	10,000	12/12	10,000
Less: forward contract shares	(1,000)	12/12	(1,000)
Jan. – Dec.	9,000	12/12	9,000

Therefore, the denominator is 9,000.

3 Determine basic EPS

Basic EPS = $115,000 ÷ 9,000 = $12.78 (see additional information below the diluted EPS calculations)

Diluted EPS

1 Identify potential common shares

The forward contract requires physical settlement by repurchase of a fixed number of common shares in exchange for cash. Therefore, the reverse treasury stock method is not applicable, and Steps 2 to 4 do not apply (see section 6.15.30).

2 For each potential common share, calculate EPIS

Not applicable.

3 Rank the potential common shares

Not applicable.

4 Determine basic EPS from continuing operations

Basic EPS is $12.78 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

Because the shares underlying the forward contract were already deducted from basic EPS, diluted EPS is the same as basic EPS.

Diluted EPS = $12.78

Additional information about both calculations

The basic and diluted EPS calculations are not adjusted for:

— the interest cost related to the forward purchase contract, because that amount is already included in income available to common shareholders;

— the price to be paid on settlement of the forward purchase contract, because total equity was reduced at inception of the contract based on the then-current common share price; or

— the weighted-average price of ABC's common shares for the year, because the contract is not subject to the reverse treasury stock method.

Scenario 2: Dividends underlying the forward contract do not revert back to ABC

EPS calculations – Year 2

EPS at a glance

	Basic	Diluted
Numerator	$103,500	$103,500
Denominator	9,000	9,000
EPS	$11.50	$11.50

Using the same background, dividends on the shares underlying the forward contract do not revert back to ABC (i.e. the current holder of those shares would retain any dividends during the period of the forward contract), so the two-class method of calculating basic and diluted EPS is applied.

Under the two-class method, income available to common shareholders is reduced in the basic and diluted EPS calculations for the undistributed earnings that are allocable to the holders of the shares underlying the forward contract.

Any dividends paid to holders of the shares underlying the forward contract would already be recorded as interest cost, so no further numerator adjustment is required for actual distributions in the EPS calculation for the shares underlying the forward contract. See section 5.3 for guidance on applying the two-class method.

Income (loss) available to common shareholders	$115,000
Less: dividends paid (other than for the shares underlying the forward contract)	-
Undistributed Year 2 earnings	$115,000

Because dividends on common shares underlying the forward contract do not revert back to ABC, holders of those shares are entitled to ABC's undistributed earnings on a share-for-share basis with all other holders of common shares. The amount of undistributed earnings these holders are entitled to is determined as follows.

> ((100% × 1,000 common shares underlying the forward contract) ÷ ((100% × 1,000 common shares underlying the forward contract) + (100% × 9,000 outstanding common shares not underlying the forward contract))) × $115,000 undistributed earnings = $11,500.

Common shareholders are also entitled to their share of the undistributed earnings for Year 2. That amount is determined as follows.

> ((100% × 9,000 outstanding common shares not underlying the forward contract) ÷ ((100% × 1,000 common shares underlying the forward contract) + (100% × 9,000 outstanding common shares not underlying the forward contract))) × $115,000 undistributed earnings = $103,500.

Income (loss) available to common shareholders	$115,000
Less: income allocated to holders of common shares underlying the forward contract	(11,500)
Income allocated to outstanding common shares not underlying the forward contract	$103,500
Weighted-average number of common shares	10,000
Less: weighted-average number of common shares to be repurchased for cash under the forward contract	(1,000)
Adjusted weighted-average number of common shares	9,000
Basic and diluted EPS ($103,500 ÷ 9,000 shares)	$11.50

Basic and diluted EPS of $11.50 under the two-class method in this scenario is equal to the basic and diluted EPS amount that would have been calculated if (1) the two-class method were not applied and (2) the shares underlying the forward contract were not deducted from the denominator in the EPS calculation: $115,000 ÷ 10,000 shares = $11.50 per share.

The basic and diluted EPS calculations are not adjusted for:

— the interest cost related to the forward purchase contract, because that amount is already included in income available to common shareholders;

— the price to be paid on settlement of the forward purchase contract, because total equity was reduced at inception of the contract based on the then-current common share price; or

— the weighted-average price of ABC's common shares for the year, because the contract is not subject to the reverse treasury stock method (see section 6.15.30).

Question 6.15.35

How is the reverse treasury stock method applied to an instrument with a variable exercise price or number of shares?

Interpretive response: When a written put option or forward purchase contract is for a variable number of shares (or has a variable exercise/contract price), if the variability is based only on the passage of time (e.g. terms vary by calendar quarter), the reverse treasury stock method is applied using the alternative (as per the contract terms) that is most advantageous to the holder at any point during the term of the contract. For example, if the option price increases each year over a three-year period, the highest price is used to calculate the reverse treasury stock method. [260-10- 45-21]

When the variability is not based only on the passage of time, we believe an entity calculates the number of shares potentially repurchased following the guidance on multiple conversion or exercise bases in section 4.4.40, which applies to the treasury stock method. This means the entity uses the average market price during the period, referred to as the variable denominator guidance, unless the guidance on contingently issuable shares applies. [260-10-45-21A, 45-52]

Some entities use a market price formula, specifying as the market price input the average of the prices for a specified period immediately preceding the period end. This methodology is consistent with the guidance on contingently issuable shares, which states that diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period, or average for that period, if applicable, if the effect is dilutive (see section 6.10). However, an entity cannot project future share prices. [260-10-45-52]

Which guidance applies – the contingently issuable shares guidance or the variable denominator guidance – is not always clear. Therefore, judgment may need to be applied, considering the terms of the contract. Based on our informal discussions with the FASB staff, paragraph 260-10-45-21A (which was introduced by ASU 2020-06) was not intended to change the application of the contingently issuable shares guidance.

See Question 4.4.100 when the variable terms are connected to a dividend. A numerator adjustment may also be required if the instrument is liability-classified but presumed share-settled for EPS purposes (see section 4.4.30). Question 6.15.30 provides further guidance on forward purchase contracts.

Observation

Number of shares to be issued vs number of shares to be included in diluted EPS under the reverse treasury stock method

When the *number of shares to be repurchased* is variable, an entity considers the contract terms to determine how to calculate the variable number of shares (see Question 6.15.35). The number of shares to be repurchased may vary based on the share price or there may be a contingency that affects the number of shares or settlement amount. In this case, the share price to be used may be a period-end share price. However, the average share price is always used to determine the *number of 'new' shares deemed to have been issued* (step ii of the reverse treasury stock method). [260-10-45-21, 45-21A, 45-23]

Question 6.15.38

How is the reverse treasury stock method applied when there is a cashless exercise (i.e. net-share settlement) provision that may be elected to cover the exercise price?

Background: In a cashless exercise (i.e. net-share settlement) of a written put option or a forward purchase contract that is recognized as a liability, the entity issues shares equal to the intrinsic value of the contract. The intrinsic value is equal to the difference between the market value of the underlying shares at settlement (or another value as specified in the contract) and the exercise or forward price. Cashless exercise is similar to two transactions occurring simultaneously: gross settlement of the instrument (repurchase of the shares) and an immediate issuance of shares in an amount equivalent to the exercise price.

Interpretive response: When a net-share settlement provision exists (whether optional or required), we believe the reverse treasury stock method is applied in the normal manner, assuming gross settlement of the contract. The average share priced is used to determine the *number of 'new' shares deemed to have been issued* (step ii of the reverse treasury stock method), and the actual terms of the net-share settlement feature are ignored. This is done in keeping with the principles of using an average market price in the reverse treasury stock method, even though net-share settlement, if elected, may be based on the current market price of the shares. [260-10-45-21A]

The numerator adjustment for the after-tax remeasurement gain or loss is considered when determining the dilutive effect of the contract.

Question 6.15.40

How is EPS affected by an accelerated share repurchase program?

Background: An accelerated share repurchase program is a combination of transactions that allows an entity to repurchase a targeted number of its shares immediately and to determine the final purchase price of those shares using an average market price over a fixed period of time. It generally involves an initial up-front payment to a financial institution for the initial purchase of the shares, and a forward contract to settle the price of the shares in the future. Topic 505 requires an entity to account for an accelerated share repurchase program that involves the initial purchase of treasury stock and a net-share-settled forward sale contract as two separate transactions:

- a treasury stock purchase; and
- a net-settled forward contract.

The treasury stock transaction causes an immediate reduction of the outstanding shares that an entity uses to calculate the weighted-average number of common shares outstanding for both basic and diluted EPS. An entity calculates the effect of the net-settled forward contract on diluted EPS under Topic 260.

Interpretive response: The EPS guidance in Topic 260 is applied to accelerated share repurchase transactions. An entity evaluates contracts that include features not present in the transaction described in Topic 505 (i.e. explicit interest rate features) to determine their accounting and EPS effect. If the forward contract in an accelerated share repurchase transaction contains participating rights, the entity applies the two-class method of calculating basic EPS to the separate forward contract component of the transaction. Participating rights may be present explicitly (e.g. forward contract price is adjusted for all cash dividends) or implicitly (e.g. parties to the forward contract agree to renegotiate the contract price if the actual dividend rate during the contract period differs from the expected dividend rate).

Some features in accelerated share repurchase arrangements may raise questions as to whether the treasury stock repurchase is separable from the forward contract for accounting and EPS purposes. For example, if an entity continues to earn interest on funds deposited toward the treasury stock repurchase until a related broker short sale arrangement is settled, this may indicate that the entire contract is a prepaid variable share-settled forward contract and that the entity should not exclude repurchased shares from basic EPS until they are no longer contingently returnable. All relevant facts and circumstances should be considered. Example 13 in Topic 260 (reproduced below) illustrates the effect of accelerated share repurchase programs.

Excerpt from ASC 260-10

• > Example 13: Accelerated Share Repurchase Programs

55-88 Example 1 in Subtopic 505-30 (see paragraph 505-30-55-1) illustrates the accounting for what is sometimes described as an accelerated share repurchase program. In that Example, separate transactions involving a treasury stock purchase and a forward contract are addressed. This Example addresses the EPS consequences of those transactions.

55-89 The treasury stock transaction would result in an immediate reduction of the outstanding shares used to calculate the weighted-average common shares outstanding for both basic and diluted EPS. The effect of the forward contract on diluted EPS would be calculated in accordance with this Subtopic.

Excerpt from ASC 505-30

• > Example 1: Accelerated Share Repurchase Program

55-1 This Example illustrates the guidance in paragraph 505-30-25-5 by identifying the two separate transactions, namely a treasury stock purchase and a forward contract, that are present in what is sometimes described as an accelerated share repurchase program.

55-2 The treasury stock purchase is as follows.

55-3 Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of those shares, and sells the shares short to Company A on July 1, 1999, at the **fair value** of $50 per share. Company A pays $50,000,000 in cash to Investment Banker on July 1, 1999, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

55-4 The forward contract is as follows.

55-5 Company A simultaneously enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999, settlement date, if the volume-weighted average daily market price of Company A's common stock during the contract period (July 1, 1999, to October 1, 1999) exceeds the $50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A's option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A's common stock during the contract period is less than the $50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

55-6 Under the guidance in paragraph 505-30-25-5, an entity would account for this accelerated share repurchase program as two separate transactions:

a. As shares of common stock acquired in a treasury stock transaction recorded on the July 1, 1999, acquisition date
b. As a forward contract indexed to its own common stock.

6.16 Purchased puts and calls

Excerpt from ASC 260-10

• • > Purchased Options

45-37 Contracts such as purchased put options and purchased call options (options held by the entity on its own stock) shall not be included in the computation of diluted EPS because including them would be antidilutive. That is, the put option would be exercised only when the exercise price is higher than the market price and the **call option** would be exercised only when the exercise price is lower than the market price; in both instances, the effect would be antidilutive under both the treasury stock method and the reverse treasury stock method, respectively.

6.16.10 Overview of the instrument

This section discusses purchased puts and calls held by an entity over its own common shares.

6.16.20 EPS implications

Purchased puts and calls are ignored in both basic and diluted EPS.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator X	Numerator X Denominator X
These options are ignored in basic EPS because they are not common shares. However, an entity should consider whether the purchased puts and calls are participating securities, in which case the two-class method is used to calculate EPS (see chapter 5).	These options are ignored in diluted EPS because their assumed conversion is always antidilutive. There is a presumption that these options are exercised only when they are in-the-money – i.e. the put option would be exercised only when the exercise price is higher than the market price and the call option would be exercised only when the exercise price is lower than the market price. [260-10-45-37]

Question 6.16.10

Is the effect of purchased puts and calls included in diluted EPS calculations in periods of net loss?

Interpretive response: No. The effect of purchased puts and calls is a decrease in the number of shares outstanding (based on applying the treasury stock method for put options and the reverse treasury stock method for call options). In periods of loss, this appears to have a dilutive effect. However, because Topic 260 specifically states that the denominator is increased in diluted EPS, we believe the effect of purchased puts and calls should not be included even in periods of net loss, because this would reduce, not increase, the denominator. [260-10-45-16]

Question 6.16.15

Are purchased puts and calls that are classified as assets or liabilities included in diluted EPS calculations if the numerator adjustment would be dilutive?

Interpretive response: No. A fair value adjustment may decrease income available to common shareholders and appear to have a dilutive EPS effect. However, the effect of purchased puts and calls is a decrease in the number of shares outstanding (based on applying the treasury stock method for put options and the reverse treasury stock method for call options). Because Topic 260 specifically states that the denominator is increased in diluted EPS, we believe the effect of purchased puts and calls should not be included even when the numerator adjustment could result in an overall dilution when considering both the numerator and denominator adjustments. This is because the effect of these instruments would reduce, not increase, the denominator. [260-10-45-16]

Question 6.16.20

Are purchased puts and calls included in diluted EPS calculations to offset outstanding written options as part of a hedging strategy?

Interpretive response: No. An entity may wish to hedge the effects of written put and call options. Although an entity may employ such a hedging strategy, it may not use antidilutive instruments (i.e. purchased puts or calls) in its diluted EPS calculations to offset the effect of the hedged dilutive instruments (written put and call options). [FAS 128.BC112]

6.17 Instruments over shares in, or issued by, a subsidiary, joint venture or equity method investee

Excerpt from ASC 260-10

• > Securities of Subsidiaries

55-20 The effect on consolidated EPS of options, warrants, and convertible securities issued by a subsidiary depends on whether the securities issued by the subsidiary enable their holders to obtain common stock of the subsidiary or common stock of the parent entity. The following general guidelines shall be used for computing consolidated diluted EPS by entities with subsidiaries that have issued common stock or potential common shares to parties other than the parent entity

a. Securities issued by a subsidiary that enable their holders to obtain the subsidiary's common stock shall be included in computing the subsidiary's EPS data. Those per-share earnings of the subsidiary shall then be included in the consolidated EPS computations based on the consolidated group's holding of the subsidiary's securities. Example 7 (see paragraph 260-10-55-64) illustrates that provision.
b. Securities of a subsidiary that are convertible into its parent entity's common stock shall be considered among the potential common shares of the parent entity for the purpose of computing consolidated diluted EPS. Likewise, a subsidiary's options or warrants to purchase common stock of the parent entity shall be considered among the potential common shares of the parent entity in computing consolidated diluted EPS. Example 7 (see paragraph 260-10-55-64) illustrates that provision.

55-21 The preceding provisions also apply to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

55-22 The if-converted method shall be used in determining the EPS impact of securities issued by a parent entity that are convertible into common stock of a subsidiary or an investee entity accounted for under the equity method. That is, the securities shall be assumed to be converted and the numerator (**income available to common stockholders**) adjusted as necessary in accordance with the provisions in paragraph 260-10-45-40(a) through (b). In addition to those adjustments, the numerator shall be adjusted appropriately for any change in the income recorded by the parent (such as dividend income or equity method income) due to the increase in the number of common shares of the subsidiary or equity method investee outstanding as a result of the assumed conversion. The denominator of the diluted EPS computation would not be affected because the number of shares of parent entity common stock outstanding would not change upon assumed conversion.

6.17.10 Overview of the instrument

Potential common shares in or issued by a subsidiary, joint venture or equity method investee present specific challenges in determining the EPS amounts for the parent's or investor's financial statements. An entity with an equity method investee should consider the dilutive effect of securities issued by the equity method investee when calculating its consolidated diluted EPS. For example, securities issued by the equity method investee that enable the holder to obtain the equity method investee's common shares are considered by the entity when calculating its diluted EPS. [260-10-55-20 – 55-21]

'Instruments over shares in an investee' refers to those instruments issued to parties other than entities in the group to which they belong and that are convertible into either common shares in the subsidiary, joint venture or associate or common shares in the parent or the investor. [260-10-55-20]

The guidance in this section is also applied if options or warrants that entitle the holder to common shares in a subsidiary are issued by the parent, instead of by the subsidiary itself. [260-10-55-22]

6.17.20 EPS implications

Generally, potential common shares of an investee affect only the diluted EPS of its parent or investor. This affects the amount of earnings of the equity method investee included in the entity's numerator when calculating consolidated EPS. The numerator includes the diluted EPS of the equity method investee multiplied by the number of shares of the equity method investee owned by the entity. Therefore, a reduction of the equity method investee's diluted EPS due to increased potential common shares issued by the equity method investee results in a reduction in the entity's numerator used for calculating consolidated diluted EPS. [260-10-55-21]

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / **Denominator X**	**Numerator X / ✓** / **Denominator X / ✓**
Potential common shares over shares in or issued by an investee are ignored in basic EPS because they are not common shares of the parent or the investor.	The following points apply to instruments of an investee that may entitle their holders to common shares of the *investee*. [260-10-55-20] — They are included based on a two-step approach[1]. – *Step i:* They are first included in the diluted EPS of the investee. The effect on the investee's diluted EPS depends on the form of the instruments (see other sections in chapter 6, as appropriate). – *Step ii:* The resulting diluted EPS of the investee is then included

Potential effect on basic EPS	Potential effect on diluted EPS
	in the parent's or investor's diluted EPS based on the parent's or investor's holding of the instruments of the investee. — Unlike other potential common shares, the denominator of the diluted EPS of the parent or the investor generally is not affected because the number of common shares of the parent or the investor does not change on the assumed conversion. Instruments of an investee (e.g. convertible instruments or options) that may entitle their holders to the parent's or the investor's common shares are considered among the potential common shares of the parent or the investor. Their effect on the numerator and denominator depends on the form of the instruments (see other sections in chapter 6, as appropriate). [260-10-55-20] The following points apply to instruments issued by the parent or the investor that are convertible into common shares of an *investee*. [260-10-55-22] — They are assumed to be converted and the numerator is adjusted as necessary by the after-tax effect in the parent's or investor's earnings. — Consistent with the if-converted method (see section 4.4.30), the numerator is also adjusted for any changes in earnings recorded by the parent or investor (such as dividend income or equity method income) that is attributable to the increase in the number of outstanding common shares of the investee as a result of the assumed conversion. Unlike other potential common shares, the denominator is not affected because the number of outstanding common shares of the parent or investor would not change on assumed conversion.
Dilutive or antidilutive? See Question 6.17.10 for this discussion.	

Note:

1. An entity may elect the fair value option for an equity method investment under Subtopic 825-10 if the investor does not recognize the investee's earnings and losses. We believe the mark-to-market adjustment of the investment considers potential dilution from the investee in determining fair value and is not an adjustment to earnings available to common shareholders. Alternatively, an entity that uses the two-step approach must consider a numerator adjustment for the difference between the investee's earnings and losses and fair value mark-to-market adjustments.

The following table summarizes the effect of potential common shares on an entity's diluted EPS when an instrument was either issued by a consolidated entity or settles in shares of a consolidated entity. See Chapter 8 of KPMG Handbook, Consolidation, for discussion on parent and subsidiary relationships.

Instrument issued by:	Shares settled in common shares of:	Numerator effect	Denominator effect
Parent	Subsidiary	The potential common shares reduce the numerator of the consolidated entity's EPS calculation using either the treasury stock or if-converted method, depending on the type of instrument issued (see chapter 4). See Example 6.17.10.	There is no effect. The exercise or conversion has no effect on the number of the parent's common shares outstanding.
Subsidiary	Subsidiary	The potential common shares reduce the numerator of the consolidated entity's EPS calculation. The entity uses the subsidiary's calculation of diluted EPS (using either the treasury stock or if-converted method, depending on the type of instrument) to calculate the entity's share of the subsidiary's income.	There is no effect. The exercise or conversion has no effect on the number of the parent's common shares outstanding.
Subsidiary	Parent	The potential common shares do not affect the numerator of the consolidated entity's EPS, because the subsidiary's stock outstanding does not change upon exercise or conversion. However, if there is a	The potential common shares are included in the calculation of the consolidated entity's EPS using either the treasury stock or if-converted method, depending on the type of instrument issued.

Instrument issued by:	Shares settled in common shares of:	Numerator effect	Denominator effect
		mark-to-market adjustment or interest for the instrument, the numerator is adjusted accordingly. See Question 6.17.25.	

6.17.30 Interpretive analysis and examples

Question 6.17.10
Are an investee's instruments that may entitle their holders to common shares in the investee dilutive?

Interpretive response: It depends. For instruments of an investee that may entitle their holders to common shares in the investee, the effect on the diluted EPS at the investee level generally 'flows up' to the parent or investor level. Key drivers affecting whether the instruments are dilutive at the investee level depend on the types of instruments concerned (see other sections in this chapter, as appropriate). A dilutive instrument at the investee level is also dilutive at the parent or investor level if it decreases the investee's EPS or increases the investee's loss per share.

Instruments of an investee that may entitle their holders to the parent's or the investor's common shares may be dilutive or antidilutive, depending on the effect of the type of instruments concerned (see other sections in this chapter, as appropriate).

An instrument issued by the parent or the investor that is convertible into common shares in an investee is antidilutive if the aggregate amount of the following is an increase in the numerator:

— the adjustments to the convertible instrument in the parent's or investor's earnings for the assumed conversion; and

— the changes in dividend income or equity method earnings attributable to the assumed increase in the number of]the outstanding common shares of the investee.

Question 6.17.20

How are share-based payment awards for the subsidiary's common shares considered for a consolidated entity's EPS?

Interpretive response: A consolidated subsidiary may issue options that allow employees to obtain the subsidiary's common shares. The diluted EPS for the subsidiary's financial statements would consider the awards in the same manner as for share-based payment awards issued on the parent's equity in the consolidated financial statements.

For the parent's consolidated financial statements, the diluted EPS for the subsidiary would be multiplied by the parent's ownership interest in the subsidiary (including the shares resulting from the share-based payment awards) and the resulting product would then be included in the numerator for the consolidated diluted EPS calculation instead of in the parent's share of the earnings of the subsidiary, as would be the case had the subsidiary not issued share-based payment awards. There is no effect on the parent's diluted EPS denominator because the instruments are not related to the parent's common shares. See Example 6.17.10.

This guidance also applies to investments in joint ventures and equity method investees. [260-10-55-21]

Question 6.17.25

How are share-based payment awards issued by a subsidiary for the parent's common shares considered for EPS?

Interpretive response: A consolidated subsidiary may issue options that allow employees to obtain the parent entity's common shares. The diluted EPS for the subsidiary's financial statements does not consider these awards because they do not relate to the subsidiary's common shares.

For the parent's consolidated financial statements, the potential common shares are included in the diluted EPS denominator using the treasury stock method. No adjustment to the numerator is necessary (unless there is a mark-to-market adjustment that must be reversed) because the compensation cost is already included in the parent's share of the subsidiary's income.

Question 6.17.30

How is diluted EPS calculated when parent options will be exchanged for subsidiary options in connection with a spinoff or carve-out?

Interpretive response: In calculating diluted EPS for a spinoff or carve-out, if parent options will be exchanged for subsidiary options as part of the initial capitalization of the entity, the exchanged options should generally be treated as subsidiary options in historical calculations of diluted EPS. However, if options are later exchanged, the exchange should be accounted for only prospectively from the date it occurs. See also Question 6.9.90.

Example 6.17.10
Potential common shares in a subsidiary

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

ABC's consolidated net income for Year 1 is $4,600,000, which includes $2,700,000 related to earnings of Subsidiary.

The following additional facts are relevant.

— The number of outstanding Subsidiary shares throughout the year is 1,000,000 (of which 900,000 are owned by ABC).
— On January 1, Year 1, Subsidiary writes 100,000 call options, 20,000 of which are owned by ABC.
— Each option is to acquire one Subsidiary common share at an exercise price of $40.
— The options are classified as equity in Subsidiary's financial statements, so there is no effect on Subsidiary's earnings.
— The average market price of Subsidiary's common shares for Year 1 is $50.
— Subsidiary's net income for Year 1 is $3,000,000.

ABC and Subsidiary do not have any other potential common shares.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$4,600,000	$4,557,760
Denominator	3,000,000	3,000,000
EPS	$1.53	$1.52

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $4,600,000.

2 Determine the denominator

There is no change in the weighted-average number of common shares outstanding during the year. Therefore, the denominator is 3,000,000.

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS

1 Identify potential common shares

Although Subsidiary's stock options entitle their holders only to Subsidiary's common shares, they are nevertheless relevant for ABC's diluted EPS.

2 For each potential common share, calculate EPIS

*Effect on diluted EPS in **Subsidiary's** financial statements*

Potential adjustment to the numerator for EPIS: No adjustment is required.

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9.30), as follows.

Step i	Number of options (and shares to be issued on exercise)	100,000	(A)
	Exercise price	$400	(B)
	Assumed proceeds	**$4,000,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$50	(D)
	Number of common shares deemed repurchased	**80,000**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**20,000**	(A) – (E)

3 Rank the potential common shares

This step does not apply, because Subsidiary's options are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The two-step approach is considered to determine ABC's diluted EPS (see section 6.17.20).

Step i. Subsidiary's diluted EPS

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$3,000,000	1,000,000	$3.00	
Incremental shares from stock options	–	20,000		
Total	**$3,000,000**	**1,020,000**	$2.94	✓

Therefore, the diluted EPS in Subsidiary's financial statements is $2.94.

Step ii. 'Flow up' Subsidiary's diluted EPS into ABC's diluted EPS.

ABC's income excluding income attributable to Subsidiary[1]	$1,900,000	
ABC's share of Subsidiary's income available to common shareholders[2]	2,646,000	
ABC's share of Subsidiary's income attributable to stock options[3]	11,760	
Numerator	$4,557,760	(A)
Denominator	3,000,000	(B)
Diluted EPS of ABC	**$1.52**	(A) ÷ (B)

Notes:

1. Consolidated net income less income related to earnings of Subsidiary: $4,600,000 – $2,700,000.
2. Number of Subsidiary's common shares owned by ABC × Subsidiary's diluted EPS: 900,000 × $2.94.
3. Incremental shares from Subsidiary's stock options × (number of Subsidiary's options owned by ABC ÷ Total number of Subsidiary's options) × Subsidiary's diluted EPS: 20,000 × (20,000 ÷ 100,000) × $2.94.

Therefore, ABC includes the effect of Subsidiary's stock options in diluted EPS.

Diluted EPS = $1.52

Example 7 in Topic 260 (reproduced below) also illustrates the EPS treatment for securities over shares in a subsidiary.

Excerpt from ASC 260-10

• > Example 7: Securities of a Subsidiary – Computation of Basic and Diluted EPS

55-64 This Example illustrates the EPS computations for a subsidiary's securities that enable their holders to obtain the subsidiary's common stock based on the provisions in paragraph 260-10-55-20. The facts assumed are as follows:

55-65 Parent Entity:

a. Net income was $10,000 (excluding any earnings of or dividends paid by the subsidiary).
b. 10,000 shares of common stock were outstanding; the parent entity had not issued any other securities.
c. The parent entity owned 900 common shares of a domestic subsidiary entity.
d. The parent entity owned 40 warrants issued by the subsidiary.
e. The parent entity owned 100 shares of convertible preferred stock issued by the subsidiary.

55-66 Subsidiary Entity:

a. Net income was $3,600.
b. 1,000 shares of common stock were outstanding.
c. Warrants exercisable to purchase 200 shares of its common stock at $10 per share (assume $20 average market price for common stock) were outstanding.
d. 200 shares of convertible preferred stock were outstanding. Each share is convertible into two shares of common stock.
e. The convertible preferred stock paid a dividend of $1.50 per share.
f. No interentity eliminations or adjustments were necessary except for dividends.
g. Income taxes have been ignored for simplicity.

55-67 The following table illustrates subsidiary's EPS.

Subsidiary's Earnings per Share

Basic EPS	$3.30	Computed:	($3,600[a] - $300[b]) ÷ 1,000[c]
Diluted EPS	$2.40	Computed:	$3,600[d] ÷ (1,000 + 100[e] + 400[f])

Consolidated Earnings per Share

Basic EPS	$1.31	Computed:	($10,000[g] + $3,120[h]) ÷ 10,000[i]
Diluted EPS	$1.27	Computed:	($10,000 + $2,160[j] + $48[k] + $480[l]) ÷ 10,000

(a) Subsidiary's net income
(b) Dividends paid by subsidiary on convertible preferred stock
(c) Shares of subsidiary's common stock outstanding
(d) Subsidiary's income available to common stockholders ($3,300) increased by $300 preferred dividends from applying the if-converted method for convertible preferred stock
(e) Incremental shares from warrants from applying the treasury stock method, computed: [($20 – $10) ÷ $20] × 200
(f) Shares of subsidiary's common stock assumed outstanding from conversion of convertible preferred stock, computed: 200 convertible preferred shares × conversion factor of 2
(g) Parent's net income

(h) Portion of subsidiary's income to be included in consolidated basic EPS, computed: (900 × $3.30) + (100 × $1.50)
(i) Shares of parent's common stock outstanding
(j) Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: (900 ÷ 1,000) × (1,000 shares × $2.40 per share)
(k) Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: (40 ÷ 200) × (100 incremental shares × $2.40 per share)
(l) Parent's proportionate interest in subsidiary's earnings attributable to convertible preferred stock, computed: (100 ÷ 200) × (400 shares from conversion × $2.40 per share)

6.18 Equity-classified instruments with a down-round feature

See Appendix A for guidance that applies before adoption of ASU 2020-06.

Excerpt from ASC 260-10

25-1 An entity that presents **earnings per share** (EPS) in accordance with this Topic shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) when the down round feature is triggered. That effect shall be treated as a dividend and as a reduction of income available to common stockholders in **basic earnings per share**, in accordance with the guidance in paragraph 260-10-45-12B. See paragraphs 260-10-55-95 through 55-97 for an illustration of this guidance.

30-1 As of the date that a **down round feature** is triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance), an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)
b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

30-2 The fair values of the financial instruments in paragraph 260-10-30-1 shall be measured in accordance with the guidance in Topic 820 on fair value measurement. See paragraph 260-10-45-12B for related **earnings per share**

guidance and paragraphs 505-10-50-3 through 50-3A for related disclosure guidance.

35-1 An entity shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) each time it is triggered but shall not otherwise subsequently remeasure the value of a down round feature that it has recognized and measured in accordance with paragraphs 260-10-25-1 and 260-10-30-1 through 30-2. An entity shall not subsequently amortize the amount in additional paid-in capital arising from recognizing the value of the effect of the down round feature.

• > Freestanding Equity-Classified Financial Instrument with a Down Round Feature

45-12B For a freestanding equity-classified **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) with a **down round feature**, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

6.18.10 Overview of the instrument

A down-round feature is a provision in an equity-linked financial instrument or equity-classified convertible preferred shares (if the conversion feature has not been bifurcated under other guidance) that reduces the strike price of the financial instrument if the entity:

— sells additional common shares for an amount less than the current strike price of the equity-linked instrument; or
— issues an equity-linked instrument with a strike price below the current strike price of the financial instrument.

A down-round feature protects certain investors from a decline in an entity's share price. Although a down-round feature is not normally a significant driver of the fair value of the equity-linked instrument, the instrument's fair value is somewhat greater than a similar equity-linked instrument without a down-round feature.

A down-round feature can take many forms. Specifically, it can:

— reduce the strike price of a financial instrument to the current issuance price;

— limit the reduction in strike price by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares; or

— reduce the strike price to below the current issuance price.

A standard antidilution provision, which is designed to maintain the value of a conversion option if there are adjustments to the conversion ratio of an instrument (e.g. in an equity restructuring transaction), is not considered a down-round feature.

See also Question 8.8.170 in KPMG Handbook, Debt and equity financing.

6.18.20 EPS implications

An entity reflects the effect in EPS of a down-round feature of freestanding equity-linked financial instruments (such as warrants) or equity-classified convertible preferred shares (if the conversion feature has not been bifurcated under other guidance) only if it is triggered. An entity measures the effect of the down-round feature and accounts for it as a deemed dividend when determining income available to common shareholders in basic EPS. [260-10-25-1, 45-12B]

The effect of the down-round feature that is triggered is measured at the trigger date as the difference between the fair value of the freestanding equity-linked financial instrument or equity-classified convertible preferred shares (if the conversion feature has not been bifurcated under other guidance) *without* the down-round feature and the strike price for the instrument immediately: [260-10-30-1]

- **before** the reduction in strike price (i.e. based on the previous strike price); and
- **after** the reduction in strike price (i.e. based on the new strike price).

An entity recognizes the value related to the down-round feature as an increase in additional paid-in capital and a decrease in retained earnings (i.e. as a deemed dividend). This transfer of value reduces net income available to common shareholders. [260-10-45-12B]

The entity does not subsequently amortize the amount to additional paid-in capital. It also does not remeasure the down-round feature unless the feature is subsequently triggered. [260-10-35-1]

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / ✓ Denominator X	Numerator ✓ Denominator ✓
For equity-classified freestanding financial instruments and equity-classified convertible preferred shares (if the conversion feature has not been bifurcated under other guidance) with a down-round feature, the numerator is adjusted for the value of the down-round feature when it is triggered as a deemed dividend. [260-10-25-1, 45-12B] These instruments are generally not participating securities. Separate disclosure of EPS amounts is required for equity-classified instruments that form a	These instruments are potential common shares. The effect of warrants on diluted EPS is described in section 6.9. The adjustment to the numerator is to add back the numerator adjustment made in the basic EPS calculation. [260-10-55-97] The adjustment to the denominator is based on the additional common shares resulting from the assumed exercise of the instrument, using the treasury stock method.

Potential effect on basic EPS	Potential effect on diluted EPS
separate class of common shares. [260-10-45-59A – 45-60] Freestanding financial instruments and embedded conversion features that are classified as liabilities or as derivatives under Topic 815 and are remeasured at fair value each reporting period are not subject to this guidance.	Exercise is assumed to have occurred at the beginning of the period; or the date of issuance of the instrument, if later. [260-10-45-23] For an example of adjustments for options and warrants, see section 6.9. For examples of adjustments for convertible instruments containing a liability component, see section 6.12. For discussion about adjustments for convertible preferred shares, see section 6.14, and for examples see sections 3.3 and 3.4.
Dilutive or antidilutive? As discussed in section 6.9 with regard to options, warrants and their equivalents, whether such an equity-classified instrument is dilutive depends on whether it is in-the-money. Generally, these instruments are dilutive if they are in-the-money – i.e. the exercise price (including the fair value of any goods or services to be supplied to the entity in the future) is lower than the average market price of the common shares. However, these instruments may not be dilutive in the period in which the down-round provision is triggered, because of the numerator adjustment to add back the deemed dividend.	

6.18.30 Interpretive analysis and examples

Question 6.18.10
How is a down-round provision different from a variable exercise price?

Interpretive response: A down-round provision is a particular form of a variable price that takes effect only upon a certain specified event – i.e. the issuance of a convertible instrument at an exercise price that is lower than the instrument with the down-round provision. When a down-round provision is exercised, it is treated as a dividend, which affects basic EPS. This is different from a standard exercise price adjustment, which does not affect basic EPS but is taken into account when calculating diluted EPS under the treasury stock method.

Question 6.18.20
What types of instruments commonly are subject to the down-round features guidance?

Interpretive response: Freestanding equity-classified financial instruments that contain down-round features are subject to the down-round features guidance with respect to basic EPS. Convertible preferred shares that are equity-classified and for which the conversion feature was not bifurcated are also subject to the down-round features guidance. The most common freestanding instruments subject to this guidance are warrants that are indexed to the issuing entity's own shares and meet the additional conditions necessary for equity classification in Subtopic 815-40.

Question 6.18.30

When calculating basic EPS, does the down-round guidance apply to a warrant with provisions that reduce its strike price and simultaneously increase the number of shares to which warrant holders will be entitled?

Background: A warrant may contain provisions that reduce its strike price and simultaneously increase the number of shares that the warrant holders will be entitled to receive on exercise if the issuer sells common shares for an amount less than the warrant's currently stated strike price or issues an equity-linked financial instrument with a strike price below the warrant's currently stated strike price.

For example, ABC Corp. issues a warrant with the following terms and conditions.

- The original strike price is $10.
- If the issuer sells its common shares for less than $10 per share, the warrant's strike price will be reduced and the number of shares the warrant holder will be entitled to receive will increase based on a formula.
- The formula is designed to adjust the strike price to a level that is less than the original strike price, but greater than the price of the subsequent round of financing – i.e. the strike price adjustment will not cause the warrant to be in or at-the-money.

The number of shares to which the warrant holder will be entitled will increase by a factor equal to the original strike price divided by the adjusted strike price. Therefore, if the original strike price were to be adjusted to $8, the number of shares to which the warrant holder would be entitled would increase by a factor of 1.25 ($10 ÷ $8).

Interpretive response: The down-round guidance is silent as to any simultaneous adjustment to the number of shares that the warrant holder would be entitled to receive. Based on informal discussions with the SEC staff, we believe the down-round feature guidance with respect to basic EPS applies to a warrant that contains such provisions. Accordingly, the deemed dividend in the period that the down-round feature is triggered should reflect both the change in the strike price and the change in the number of shares issuable.

Question 6.18.35**

Are entities that do not otherwise present EPS required to recognize the value of a down-round feature when triggered?

Interpretive response: No. Topic 260 only requires *an entity that presents EPS* to recognize the effect of a down-round feature. Further, the FASB indicated in the basis for conclusions to ASU 2017-11 that this recognition and measurement model applies only to entities that present EPS. The FASB concluded that the benefits to financial statement users from requiring entities that do not otherwise present EPS to recognize the effect of a down-round trigger would not justify the costs. [260-10-25-1, ASU 2017-11 BC34]

Question 6.18.40

How does the entity calculate the effect of the down-round feature?

Interpretive response: When calculating the value of the effect of triggering the down-round feature, an entity determines:

— the fair value of the financial instrument (without the down-round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (i.e. before the strike price reduction); and

— the fair value of the financial instrument (without the down-round feature) with a strike price corresponding to the reduced strike price upon the down-round feature being triggered.

The entity determines these two fair values by applying the fair value measurement guidance in Topic 820; see KPMG Handbook, Fair value measurement. The difference between these two fair values represents the value of the effect of triggering the down-round feature. However, this is not a fair value adjustment of the instrument, but instead a valuation used for determining the value ascribed to the deemed dividend upon triggering a down-round price adjustment.

Question 6.18.50

Are there any situations in which the value of the effect of triggering the down-round feature is remeasured?

Background: An entity recognizes the value of the effect of triggering a down-round feature in an equity-classified freestanding financial instrument (e.g. a warrant that is indexed to the entity's own shares) or convertible preferred share, upon being triggered.

Interpretive response: No. When a down-round feature is triggered, the value of the effect of triggering the feature is recognized and measured under paragraphs 260-10-25-1 and 260-10-30-1 to 30-2. The value related to this triggering is not subsequently remeasured. However, the value of the effect of any subsequent triggering of that feature would also be recognized and measured under paragraphs 260-10-25-1 and 260-10-30-1 to 30-2.

Question 6.18.60

How are potential common shares included in diluted EPS for a convertible instrument with both a market price trigger and a down-round feature?

Background: ABC Corp. issues 1,000 Series A convertible bonds, with a par value of $100 each and a conversion price of $120. The bonds are convertible only when ABC's share price reaches $110 (the market price trigger). According to the terms of the convertible bond, if ABC subsequently issues convertible bonds at a lower conversion price, the conversion price of the Series A convertible bonds will be reduced accordingly (the down-round feature).

Interpretive response: ABC first considers *whether* the convertible bonds are included in diluted EPS, and then considers *how* to include them. When there is a market price contingency, the convertible bonds are still considered for inclusion in diluted EPS (see section 6.12). [260-10-45-44, 260-10-45-52]

Therefore, in the background example, ABC ignores the market price contingency and includes the convertible bonds in its diluted EPS calculations. However, due to the down-round feature, ABC follows the guidance on contingently issuable shares (see section 6.10) to determine how to include the convertible bonds in diluted EPS. ABC does not consider the effect of the down-round feature until it is actually triggered. Therefore, ABC uses the conversion price in effect at period end, following the guidance for contingently issuable shares with a market price contingency, to determine the number of potentially dilutive shares to include in diluted EPS. See also the flowchart at section 4.3. [260-10-45-44, 260-10-45-52]

Example 6.18.10

Warrants that contain a down-round feature

ABC Corp. has 3,000,000 common shares outstanding. On January 1, Year 1, ABC issues 100,000 warrants that contain a down-round feature.

The following facts are relevant.

— The warrants have a 10-year term and permit the holders to buy common shares for $10 per share and are exercisable at any time.

— Each warrant can be exercised in exchange for five common shares.

— The warrants specify that if ABC issues additional common shares for an amount less than $10 per share or issues equity-linked financial instruments with a strike price below $10 per share, the strike price of the warrants will be reduced to the issuance price of such common shares or the strike price of the equity-linked financial instruments.

- ABC classifies the warrants as equity because they do not meet the definition of a derivative in paragraph 815-10-15-83 but they do meet the conditions for the equity scope exception in paragraph 815-10-15-74(a); the down-round feature is ignored for these determinations.
- ABC has no other potential common shares.
- Net income is $4,600,000 in Year 1.

ABC issues 200,000 common shares at $8 per share on the first day of its third quarter of its fiscal year. Because this subsequent round of financing occurs at a share price below the original strike price of the warrants ($10), the down-round feature is triggered and the strike price of the warrants is reduced to $8 per share.

- The value of the effect of triggering the down-round feature is $700,000 and is calculated under paragraph 260-10-30-1.
- The average market price of ABC's common shares during Q3 of Year 1 is $9 per share.

EPS calculations – Year 1

Because the warrants are equity-classified freestanding financial instruments, the value of triggering the down-round feature is treated as a deemed dividend and deducted from income available to common shareholders upon the date the feature is triggered when calculating basic EPS. That value is added back for the purposes of calculating diluted EPS.

EPS at a glance

	Basic	Diluted
Numerator	$3,900,000	$3,900,000
Denominator	3,050,000	3,050,000
EPS	$1.28	$1.28

Basic EPS

1 Determine the numerator

The numerator is adjusted for the value of the down-round feature that is treated as a deemed dividend. ABC calculates the numerator as follows: $4,600,000 – 700,000 = $3,900,000.

2 Determine the denominator

No adjustment is necessary until the warrants are exercised and common shares are issued, because they are exercisable for more than little consideration.

There is a change in the number of outstanding shares during the year for the 200,000 issued on October 1.

ABC calculates the denominator as follows.

	Number of shares	Time weighting	Weighted average
Jan. – Sept.	3,000,000	9/12	2,250,000
Oct 1 – issuance of shares	200,000		
Oct. – Dec.	3,200,000	3/12	800,000
		12/12	
Weighted average for the year			**3,050,000**

Therefore, the denominator is 3,050,000.

3 Determine basic EPS

Basic EPS = \$3,900,000 ÷ 3,050,000 = \$1.28

Diluted EPS

1 Identify potential common shares

Options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: The adjustment for the triggering of the down-round feature included in basic EPS is added back in the diluted calculation.

\$3,900,000 + \$700,000 = \$4,600,000

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9.30), as follows.

Step i	Weighted-average number of warrants (and shares to be issued on exercise of warrants)[1]	500,000	(A)
	Exercise price	\$8	(B)
	Assumed proceeds[2]	**\$4,000,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	\$9	(D)
	Number of common shares deemed issued	**444,444**	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	**55,555**	(A) – (E)

Notes:

1. 100,000 × 50 = 500,000
2. Assumed proceeds of 100,000 warrants at $8 exercise price × 5 shares = $4,000,000

EPIS is therefore $700,000 ÷ 55,555 = $12.60

3 Rank the potential common shares

This step does not apply because the warrants are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.28 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$3,900,000	3,050,000	$1.28	
Warrants	700,000	55,555		
Total	**$4,600,000**	**3,105,000**	$1.48	✘

As the warrants are antidilutive, their effect is not included in diluted EPS.

Diluted EPS = $1.28

The following additional example is presented in Topic 260.

Excerpt from ASC 260-10

• > Example 16: Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature

55-95 Assume Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share and that Entity A presents EPS in accordance with the guidance in this Topic. The warrants have a 10-year term, are exercisable at any time, and contain a **down round feature**. The warrants are classified as equity by Entity A because they are indexed to the entity's own stock and meet the additional conditions necessary for equity classification in accordance with the guidance in Subtopic 815-40 on derivatives and hedging—contracts in entity's own equity (see paragraphs 815-40-55-33 through 55-34A for an illustration of the guidance in Subtopic 815-40 applied to a warrant with a down round feature). Because the warrants are an equity-classified freestanding **financial instrument**, they are within the scope of the recognition and measurement guidance in this Topic. The terms of the down round feature specify that if Entity A issues additional shares of its common stock for an amount less than $10 per share or issues an equity-classified financial instrument with a strike price below $10 per share, the strike price of the warrants would be reduced to the most recent issuance price or strike price, but the terms of the down round feature are such that the strike price cannot be reduced below $8 per share. After issuing the warrants, Entity A issues shares of its common stock at $7 per share. Because of the subsequent round of financing occurring at a share price below the strike price of the warrants, the down round feature in the warrants is triggered and the strike price of the warrants is reduced to $8 per share.

55-96 In accordance with the measurement guidance in paragraphs 260-10-30-1 through 30-2, Entity A determines that the fair value of the warrants (without the down round feature) with a strike price of $10 per share immediately after the down round feature is triggered is $600 and that the fair value of the warrants (without the down round feature) with a strike price of $8 per share immediately after the down round feature is triggered is $750. The increase in the value of $150 is the value of the effect of the triggering of the down round feature.

55-97 The $150 increase is the value of the effect of the down round feature to be recognized in equity in accordance with paragraph 260-10-25-1, as follows:

Retained earnings	$150	
Additional paid-in capital		$150

Additionally, Entity A reduces income available to common stockholders in its basic EPS calculation by $150 in accordance with the guidance in paragraph 260-10-45-12B. Entity A applies the treasury stock method in accordance with paragraphs 260-10-45-23 through 45-27 to calculate diluted EPS. Accordingly, the $150 is added back to income available to common stockholders when calculating diluted EPS. However, the treasury stock method would not be applied if the effect were to be antidilutive.

6.19 Employee stock ownership plans

Excerpt from ASC 718-40

General

> EPS

45-1 Dividends on preferred stock held by an employee stock ownership plan shall be deducted from net income net of any applicable income tax benefit when computing both basic and diluted earnings per share (EPS) if that preferred stock is considered outstanding (that is, if the employee stock ownership plan shares are allocated).

Leveraged Employee Stock Ownership Plans

> EPS

45-3 For purposes of computing basic and diluted earnings per share (EPS), employee stock ownership plan shares that have been committed to be released shall be considered outstanding. Employee stock ownership plan shares that have not been committed to be released shall not be considered outstanding.

45-4 Employers that use dividends on allocated employee stock ownership plan shares to pay debt service shall adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

45-5 Prior period EPS shall not be restated for changes in the conversion rates.

• > Convertible Preferred Shares

45-6 The number of common shares that will be issued on conversion of the convertible shares held by an employee stock ownership plan that have been committed to be released shall be deemed outstanding in the if-converted EPS computations for diluted EPS if the effect is dilutive. Convertible preferred shares held by the employee stock ownership plan that have not been committed to be released shall not be considered outstanding and, accordingly, would be excluded from the if-converted computations for diluted EPS.

45-7 When participants withdraw account balances containing convertible preferred shares from an employee stock ownership plan, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares or a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer shall presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash. In applying the if-converted method, the number of common shares issuable on assumed conversion, which shall be included in the denominator of the EPS calculation, shall be the greater of the following:

a. The shares issuable at the stated conversion rate
b. The shares issuable if the participants were to withdraw the shares from their accounts.

45-8 Shares issuable on assumed withdrawal shall be computed based on the ratio of the average fair value of the convertible stock (or, if greater, its stated minimum value) to the average fair value of the common stock.

Nonleveraged Employee Stock Ownership Plans

> EPS

45-9 All shares held by a nonleveraged employee stock ownership plan shall be treated as outstanding in computing the employer's earnings per share (EPS), except the suspense account shares of a pension reversion employee stock ownership plan, which are not treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged employee stock ownership plan holds convertible preferred stock, the guidance in paragraphs 718-40-45-6 through 45-8 for leveraged employee stock ownership plans shall be considered.

6.19.10 Overview of the instrument

An ESOP is an employee benefit plan that enables its participants to participate in any changes in stock price while also obtaining certain tax benefits. An ESOP invests primarily in employer stock and meets certain requirements of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986; therefore, most ESOPs are considered qualified compensation arrangements. There may be other types of employee stock ownership plans, but the discussion that follows focuses on ESOPs that meet these requirements, which are the most common.

An ESOP has an account for each participating employee. The sponsor (employer) funds the ESOP with common shares or noncallable convertible preferred shares that are either issued or purchased by the entity. The shares are then allocated to individual employee accounts. The entity records compensation expense for the fair value of the shares issued or the amount funded to purchase the shares. The timing of the compensation expense depends on the type of plan, as discussed below.

Types of ESOPs

There are two types of ESOPs.

- **Leveraged ESOP.** The ESOP borrows money to acquire shares. Shares purchased by the plan are used as collateral for the ESOP's debt, and are held in a suspense account (and reported in a contra-equity account by the sponsor). The ESOP shares are then released as the debt is repaid (serviced) by contributions from the sponsor, and as they are earned by the participants. The debt is repaid with periodic contributions of the sponsor and/or dividends received on the ESOP shares. Leveraged ESOPs can also be funded by pension plan reversions (see below). [718-40-05-3]

  Shares held by a leveraged ESOP are classified as follows.

  - **Allocated shares.** ESOP shares that have been allocated to individual employee (i.e. participant) accounts. These shares are held by the ESOP until distributed to the employees at a future date, such as upon termination or retirement. [718-10-05-4]
  - **Committed-to-be-released shares.** ESOP shares that are committed to be released by a future scheduled and committed debt service payment and will be allocated to employees for service provided in the current accounting period. Committed-to-be-released ESOP shares may exist if the allocation of the ESOP shares to individual participant accounts occurs at the end of the ESOP's fiscal year, even though the

ESOP shares are earned ratably during an accounting period as the employee performs the services. [718-40-20]

  - **Unallocated (or suspense account) shares.** ESOP shares that are neither allocated to employees nor committed to be released but held in a suspense account.

- **Nonleveraged ESOP.** The entity does not borrow money to acquire shares (in contrast to a leveraged ESOP), but periodically contributes its shares or cash to the ESOP on behalf of employees. If cash is contributed, it is then used to purchase shares. The ESOP shares are held directly in participant accounts and are referred to as 'contributed shares'. An exception involves ESOP shares contributed as part of a pension plan reversion that are still held in a suspense account and are treated similarly to shares in a leveraged ESOP (see below). [718-40-05-4]

Sometimes shares are contributed to an ESOP as part of a pension plan reversion under IRC section 4980. Such ESOP shares usually exceed the amount permitted by the IRS to be allocated to an ESOP in a single year, and therefore are initially held in a suspense account. They are then released over time according to the ESOP's permitted share allocation, or as replacement shares for dividends used for debt service (see below). [718-40-25-5, 25-17]

ESOP dividends

Shares held by the ESOP (whether common or convertible preferred shares) generally earn dividends. These dividends may either be paid to participants or, in a leveraged ESOP, used to repay the debt (i.e. debt service).

- **Dividends are paid**.
  - **Leveraged ESOP**. Dividends on allocated ESOP shares are recorded in retained earnings. Dividends on unallocated ESOP shares are not treated as dividends and are recorded as compensation cost. [718-40-25-16]
  - **Nonleveraged ESOP**. Dividends are recorded in retained earnings, except for those on shares contributed to an ESOP as part of a pension plan reversion, which are treated the same way as dividends on suspense account shares of leveraged employee stock ownership plans. [718-40-25-20]
- **Dividends are used for debt service (leveraged ESOP).** When this occurs with dividends on allocated shares, the sponsor replaces the amount of dividends paid with committed-to-be-released ESOP shares of equal value, which are referred to as replacement shares. Dividends on the allocated ESOP shares are recorded in retained earnings. [718-40-25-15]

Generally, compensation cost is recorded for the contribution (or fair value) of ESOP shares committed to be contributed during the period in a nonleveraged ESOP, and for the fair value of ESOP shares committed to be released in a leveraged ESOP. Compensation cost is also recorded for any dividends paid on unallocated shares to participants or added to their accounts. [718-40-25-13, 25-16, 30-5]

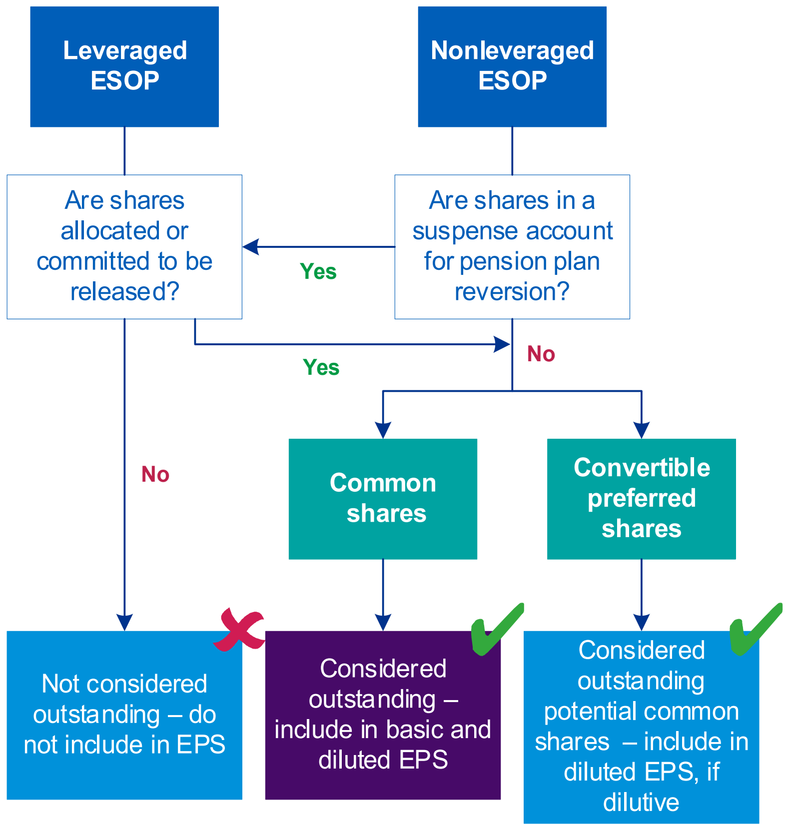
6.19.20 EPS implications

Subtopic 718-40 discusses the EPS effects of ESOP shares acquired on or after January 1, 1993. An entity may also apply Subtopic 718-40 to ESOP shares acquired before January 1, 1993, but the entity is entitled to grandfather the previous guidance (SOP 76-3) to those shares. ESOPs that do not meet the requirements of the legislation mentioned in section 6.19.10 are included in EPS following guidance in Topic 260 or other ASC topics. The remainder of this section is based on the guidance in Subtopic 718-40 unless otherwise noted.

The EPS effects of an ESOP depend on its type. The key differences are when the shares are considered outstanding and how dividends are treated.

	Leveraged ESOP	Nonleveraged ESOP
When shares are considered outstanding for EPS	Once the shares have been allocated to individual employees, or when committed to be released (see section 6.19.10), if earlier.	All shares held by a nonleveraged ESOP are considered outstanding, regardless of whether they are vested, except for those that are in a suspense account as part of a pension plan reversion (see section 6.19.10). Such suspense account shares are treated similarly to shares of a leveraged ESOP and are not considered outstanding until they are contributed into the nonleveraged ESOP. [718-40-45-9]
Effect of dividends	— Only dividends on outstanding (i.e. allocated or committed-to-be-released) ESOP shares are treated as dividends (numerator adjustment for convertible preferred shares). — Dividends on unallocated ESOP shares are not treated as dividends, so there is no numerator adjustment. [718-40-25-16]	Treated as dividends for all shares except those contributed to an ESOP as part of a pension plan reversion, which are treated the same way as dividends on unallocated shares of leveraged ESOPs. [718-40-25-20]

The following diagram further clarifies the difference between how the type of ESOP affects how the shares are included in EPS, assuming they are not participating securities.



For purposes of calculating basic and diluted EPS, the employer considers the committed-to-be-released ESOP shares to be outstanding, because it exchanged the ESOP shares for employee services.

In all types of ESOPs, all outstanding ESOP shares are treated similarly to those held by investors – i.e. common shares and convertible preferred shares are including in basic and diluted EPS using the Topic 260 principles that apply to those shares.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / ✓ **Denominator X / ✓**	**Numerator X / ✓** **Denominator X / ✓**
Leveraged: Allocated and committed-to-be released ESOP common shares are considered outstanding and included in the denominator. Such common shares are included in basic EPS on a weighted-average basis. [718-10-45-2 – 45-3] If allocated and committed-to-be-released preferred shares are also participating securities (see section 5.2), basic EPS is calculated using the two-class method. The potential adjustments to the numerator of basic EPS for outstanding preferred shares are discussed in section 6.14.20.	Outstanding convertible preferred shares are considered outstanding potential common shares regardless of whether they are vested and are included in diluted EPS if dilutive using the if-converted method. See section 6.14.20 for an analysis of the potential effect of preferred shares on diluted EPS. [718-40-45-6] In addition to numerator adjustments described in section 6.14.20, an adjustment to the numerator must also be made for the after-tax effect of the difference in compensation expense that would have been recorded had the ESOP

Potential effect on basic EPS	Potential effect on diluted EPS
If dividends are used to repay debt in a leveraged ESOP, the shares issued or issuable in respect of allocated or committed-to-be-released shares are considering outstanding and included in the denominator of basic EPS (assuming the shares issued are at the same value as the dividend). **Nonleveraged:** All ESOP shares are considered outstanding. Common shares are included in the denominator of basic EPS, whether or not vested, except for those held in a suspense account related to a pension reversion plan (see section 6.19.10). Such suspense account shares are treated similarly to shares of a leveraged ESOP and are not considered outstanding until they are contributed into the nonleveraged ESOP. Common shares are included in basic EPS on a weighted-average basis. [718-40-45-9] **All ESOPs:** The potential adjustments to the numerator of basic EPS for dividends on outstanding convertible preferred shares are discussed in section 6.14.20. If convertible preferred shares are also participating securities (see section 5.2), basic EPS is calculated using the two-class method.	shares been common shares (as a result of differing dividend rates). See Case C from Subtopic 718-40, paragraphs 55-28 to 55-29, presented at section 6.19.30. If dividends are used to repay debt in a leveraged ESOP, convertible preferred shares issued or issuable in respect of allocated or committed-to-be-released ESOP shares are considering outstanding and included in diluted EPS.
Dilutive or antidilutive? Common shares held by an ESOP are dilutive. Determining whether or not preferred shares are dilutive, is the same for ESOPs as for any preferred share issuance. For a discussion of the dilutive effect of preferred shares, see section 6.14.20.	

Observation

ESOP shares acquired before January 1, 1993 (SOP 76-3)

ESOP shares acquired before January 1, 1993, are not subject to the requirements of Subtopic 718-40. SOP 76-3, which may be applied to these ESOP shares, does not distinguish between leveraged and nonleveraged ESOPs. Under SOP 76-3, all shares held by an ESOP are treated as outstanding and included in both basic and diluted EPS. [SOP 76-3]

6.19.30 Interpretive analysis and examples

Question 6.19.10
How are unallocated ESOP shares treated for EPS?

Interpretive response: ESOP shares that are unallocated, and therefore have not been committed to be released and were not yet exchanged for employee services, are not treated as outstanding for determining basic or diluted EPS. AcSEC believes this conclusion is consistent with its conclusion on reporting the release of ESOP shares because the ESOP shares are not treated as issued until they are committed to be released. In the basis for conclusions to SOP 93-6, AcSEC stated that it believes ESOP shares that are uncommitted are analogous to unpaid stock subscriptions. [718-40-45-3, SOP 93-6 BC]

Question 6.19.20
How is diluted EPS determined when the ESOP entitles a participant to receive common shares or cash when withdrawing account balances containing convertible preferred shares?

Background: Some ESOPs entitle participants with account balances containing convertible preferred shares to receive common shares or cash with a value equal to either (1) the fair value of the convertible preferred shares, or (2) a stated minimum value per share, when withdrawing account balances from the ESOP. If the fair value of the common shares issuable upon conversion of the convertible preferred shares is less than the fair value of the convertible preferred shares or the stated minimum value, as applicable, then the amount to be received in common shares may be less than what would be received in cash. In order to compensate for this, the entity may either allocate ESOP shares for the difference, or make up the shortfall in cash.

Interpretive response: When calculating diluted EPS using the if-converted method, the entity does not need to assume that the participant will withdraw the ESOP shares, but it does include the greater of the shares that would be issuable upon conversion or issuable upon withdrawal. The entity assumes that it will settle any shortfall in shares, unless there is past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash. This is analogous to the Topic 260 guidance on contracts that may be settled in shares or cash (see section 6.13). [718-40-45-7]

The entity performs its calculations using the average, rather than closing, market price of the shares – i.e. the ratio of the average price of the preferred shares to the common shares. [718-40-45-8]

Question 6.19.30

When an ESOP has convertible preferred shares, what number of respective common shares is used in the denominator of the diluted EPS calculation?

Background: As discussed in Question 6.19.20, some ESOPs entitle participants to receive common shares or cash when withdrawing account balances that contain convertible preferred shares.

Interpretive response: When applying the if-converted method to such ESOPs, the number of common shares assumed issued upon conversion is the greater of: [718-40-45-7]

- the shares issuable at the stated conversion rate; or
- the shares issuable if the participants were to withdraw the ESOP shares from their accounts (including any compensation for shortfall).

Question 6.19.40

How does variability in the conversion rate affect the denominator adjustment for convertible preferred shares in an ESOP?

Interpretive response: Because the varying conversion rates associated with convertible preferred shares are a function of changes in fair values and unknown until they occur, the additional shares issuable are calculated based on current period fair value for the diluted EPS calculation. This is consistent with the general approach to contingencies in Topic 260 and with the guidance on determining the denominator for diluted EPS when there are multiple or varying conversion rates (see section 4.4.40). Consistent with the guidance in Topic 260, EPS amounts that were reported in prior periods based on different conversion rates are not restated. [718-40-45-5]

Question 6.19.50

Are allocated but unvested shares in a nonleveraged ESOP considered participating securities?

Interpretive response: No. We believe that because all shares held by a nonleveraged ESOP – except for those relating to a suspense account (see section 6.19.20) – are considered outstanding, there is no need to consider the unvested ESOP shares as participating securities (see chapter 5). This assumes that the dividend rights for both the vested and unvested ESOP shares are the same.

Question 6.19.60

Are convertible preferred shares in a nonleveraged ESOP considered participating securities?

Interpretive response: If the convertible preferred shares contain rights to participate in dividends with common shareholders, then the ESOP shares meet the definition of a participating security and basic EPS is calculated using the two-class method (see chapter 5).

Question 6.19.70

How are redeemable shares held by an ESOP and classified as temporary equity treated for EPS?

Background: ESOP shares may sometimes be classified as temporary equity. For example, if ESOP shares are not readily tradeable, most plans require that the entity provide a put option allowing the employee, upon termination of employment, to sell back the shares to the entity at an amount meant to approximate fair value. [718-40-25-2]

Interpretive response: Question 3.3.20 discusses the EPS effect of redeemable securities that are classified as temporary equity. While paragraph 480-10-S99-3A prescribes different measurement options for redeemable shares held by an ESOP, these shares are included in EPS in the same manner as non-ESOP redeemable shares, as described in Question 3.3.20. It makes no difference if the shares are allocated. [480-10-S99-3A.12, 23]

Question 6.19.80

Are outstanding shares held by an ESOP treated similarly to other shares of the same class?

Interpretive response: Yes. When calculating EPS, when there is only one class of shares (i.e. with the same rights) or when using the two-class method, shares held by the ESOP that are considered outstanding are included in the calculations in the same manner as similar shares that are not held by the ESOP.

Question 6.19.85

What is the EPS effect of dividends on ESOP preferred shares that are not participating securities?

Interpretive response: Dividends on outstanding preferred shares held by an ESOP are deducted from income available to common shareholders, along with any other applicable adjustments to basic EPS as discussed in section 3.3. This deduction is reversed when calculating diluted EPS. [718-40-45-1]

Question 6.19.90

What is the effect on basic EPS of dividends on allocated shares when the dividends are used to repay debt in a leveraged ESOP?

Interpretive response: When dividends are used to repay debt in a leveraged ESOP, replacement shares are issued to the plan participants in lieu of the cash dividends. Because the fair value of the shares received equals the value of the cash dividend, the only EPS effect is on the denominator, to account for the additional shares issued. If the replacement shares are common shares, these are included in the denominator for basic EPS when they are committed to be released. For convertible preferred shares, there is no effect on basic EPS; however, if the convertible preferred shares are participating securities (see chapter 5), then basic EPS is affected and the two-class method is used. Questions 6.19.100 and 6.19.110 discuss the related diluted EPS effects.

Question 6.19.100

When dividends on allocated convertible preferred shares are used to repay debt in a leveraged ESOP, what is the effect on diluted EPS?

Background: When an entity uses dividends on allocated ESOP shares to repay debt, participants receive their dividends in shares rather than in cash. Generally, compensation expense is recorded when unearned ESOP shares are committed to be released to fund the participant account. However, when the ESOP shares are committed to be released as dividends, compensation expense is not recorded for those shares, and their issuance is recorded against a reduction of dividends payable.

Interpretive response: As discussed in section 4.4.30, dividends on convertible preferred shares are adjusted in the numerator of basic EPS. When calculating diluted EPS using the if-converted method, it is assumed that the convertible preferred shares were converted to common shares at the beginning of the year, and therefore the numerator adjustment from basic EPS is reversed. [260-10-45-40]

Additionally, a numerator adjustment may be necessary if the common share dividend is different from the preferred share dividend. This is because the proportion of committed-to-be-released ESOP shares needed to replace dividends on allocated ESOP shares would be smaller after the assumed conversion. Conversely, the proportion of committed-to-be-released ESOP shares used to compensate participants for services would be greater after the assumed conversion, resulting in a higher compensation expense.

The availability of a greater proportion of released ESOP shares to compensate participants has a consequential effect on income that is adjusted in the numerator of diluted EPS, as described in Question 4.4.20. [718-40-45-4]

Question 6.19.110

How are dividends on *unallocated* convertible preferred shares that are used to repay debt in a leveraged ESOP treated for EPS?

Interpretive response: Dividends on *unallocated* ESOP shares used to repay debt are not treated as dividends for accounting purposes, because those ESOP shares are not considered outstanding. An entity does not consider those dividends when using the if-converted method in its diluted EPS calculation. [718-40-45-3]

Question 6.19.120

Is a numerator adjustment necessary if a leveraged ESOP pays dividends on unallocated preferred shares to participants or adds them to participant accounts?

Interpretive response: No. Dividends on unallocated convertible preferred shares paid to participants or added to participant accounts in a leveraged ESOP are treated as compensation cost because those ESOP shares are not considered outstanding. Therefore, no numerator adjustment is necessary for the dividend because the effect is already included in earnings.

Further, because the dividends and the resulting compensation provided to participants are discretionary, as they are not provided to the participants as a right of the preferred shares, there is no consequential effect on income to be adjusted (see section 4.4.20 and Question 4.4.20). Therefore, compensation cost arising from those dividends should not be adjusted in the numerator of the if-converted EPS calculation. [718-40-25-16, 45-3]

Question 6.19.130

How do dividends on shares held by a nonleveraged ESOP affect EPS?

Interpretive response: It depends on whether the dividends are on common or preferred shares.

— **Dividends on common shares.** If the dividends are paid in cash, they have no effect on EPS; if they are paid in shares, they affect the EPS denominator as those shares are issued.

— **Dividends on convertible preferred shares.** Dividends on convertible preferred shares are an adjustment to income available to common shareholders when calculating basic EPS. The adjustment is reversed when calculating diluted EPS; see also section 6.14.20. If the convertible preferred shares are participating securities, the two-class method is used (see chapter 5). [718-40-45-1, 45-9]

Question 6.19.140

How do forfeitures of allocated ESOP shares affect EPS?

Interpretive response: Forfeitures of allocated ESOP common shares may affect an entity's EPS calculation. This is because, upon forfeiture, the shares are reclassified from allocated to unallocated, and unallocated shares are not included in basic EPS.

The following Subtopic 718-40 examples illustrate the accounting and EPS effect of shares held by ESOPs. The following excerpts include only the relevant EPS sections for illustrative purposes.

The Subtopic 718 examples presented below cover the following scenarios:

— Example 1: Leveraged ESOP
  – Case A: Common stock financed by direct loan (this example does not illustrate how EPS is affected/calculated)
  – Case C: Convertible preferred stock financed by a direct loan

— Example 2: Leveraged ESOP with convertible preferred stock to fund a 401(k) plan with an employer loan.

Excerpt from ASC 718-40

Leveraged Employee Stock Ownership Plans

> Illustrations

• > Example 1: Employee Stock Ownership Plan Leveraged with a Direct or Indirect Loan

55-3 The following Cases illustrate the guidance in paragraphs 718-40-25-7 through 25-17; 718-40-30-1 through 30-4; 718-40-35-1; 718-40-40-1 through 40-7; and 718-40-45-3 through 45-8:

a. A common-stock leveraged employee stock ownership plan with a direct loan (Case A)
b. A common-stock leveraged employee stock ownership plan used to fund the employer's match of a 401(k) savings plan with an indirect loan (Case B)
c. A convertible-preferred-stock leveraged employee stock ownership plan with a direct loan (Case C).

• • > Case A: A Common-Stock Leveraged Employee Stock Ownership Plan with a Direct Loan

55-4 This Case illustrates a common stock leveraged employee stock ownership plan with a direct loan. This Case has the following assumptions:

a. On January 1, Year 1, Entity A establishes a leveraged employee stock ownership plan.
b. The employee stock ownership plan borrows $1,000,000 from an outside lender at 10 percent for 5 years and uses the proceeds to buy 100,000 shares of newly issued common stock of the sponsor for $10 per share, which is the market price of those shares on the date of issuance.
c. Debt service is funded by cash contributions and dividends on employer stock held by the employee stock ownership plan.
d. Dividends on all shares held by the employee stock ownership plan are used for debt service.
e. Cash contributions are made at the end of each year.
f. The year-end and average market values of a share of common stock follow.

Year	*Year-End*	*Average*
1	$11.50	$10.75
2	9.00	10.25
3	10.00	9.50
4	12.00	11.00
5	14.40	13.20

g. The common stock pays normal dividends at the end of each quarter of 12.5 cents per share ($50,000 for the employee stock ownership plan's shares each year). Accordingly, in this Case, the average **fair value** of shares is used to determine the number of shares used to satisfy the employers' obligation to replace dividends on **allocated shares** used for debt service.
h. Principal and interest are payable in equal annual installments at the end of each year. Debt service is as follows.

Year	*Principal*	*Interest*	*Total Debt Services*
1	$163,800	$100,000	$263,800
2	180,200	83,600	263,800
3	198,200	65,600	263,800
4	218,000	45,800	263,800
5	239,800	24,000	263,800
	$1,000,000	$319,000	$1,319,000

i. The number of shares released each year is as follows.

Year	*Dividends*	*Compensation*	*Total*
1	0	20,000	20,000

2	976	19,024	20,000
3	2,105	17,895	20,000
4	2,727	17,273	20,000
5	3,030	16,970	20,000

j. The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares by the average fair value of a share of common stock (for Year 2: $10,000 divided by $10.25 equals 976 shares). In this illustration, the remaining shares are released for compensation (for Year 2: 20,000 less 976 equals 19,024 shares).
k. Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participant accounts the following year. Shares released and allocated follow.

	Cumulative Number of Shares			Year-End
Year	*Released*	*Allocated*	Average Shares *Released*	Suspense *Shares*
1	20,000	0	10,000	80,000
2	40,000	20,000	30,000	60,000
3	60,000	40,000	50,000	40,000
4	80,000	60,000	70,000	20,000
5	100,000	80,000	90,000	0

l. Income before employee stock ownership plan related charges is as follows.

Year	*Income*
1	$1,800,000
2	1,900,000
3	2,000,000
4	2,100,000
5	2,200,000

m. All interest cost and compensation cost are charged to expense each year.
n. Excluding employee stock ownership plan shares, 1,000,000 shares are outstanding on average each year.
o. Entity A follows the guidance in Subtopic 740-10.
p. Entity A's combined statutory tax rate is 40 percent each year.
q. Entity A's only book-tax differences are those associated with its employee stock ownership plan.
r. No valuation allowance is necessary for deferred tax assets.

55-5 The following table sets forth Entity A's employee stock ownership plan-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	Principal	Unearned Employee Stock Ownership Plan Shares	Paid-In Capital	Dividends	Interest Expense	Compensation Expense	Cash
Notes	(1)	(2)	(3)	(4)	(1)	(5)	(6)
1	$163,800	$(200,000)	$(15,000)	$ -	$100,000	$215,000	$(263,800)
2	180,200	(200,000)	(5,000)	10,000	83,600	195,000	(263,800)
3	198,200	(200,000)	10,000	20,000	65,600	170,000	(263,800)
4	218,000	(200,000)	(20,000)	30,000	45,800	190,000	(263,800)
5	239,800	(200,000)	(64,000)	40,000	24,000	224,000	(263,800)
Total	$1,000,000	$(1,000,000)	$(94,000)	$100,000	$319,000	$994,000	$(1,319,000)

Notes:

(1) See the table in (h) of the preceding paragraph.

(2) Total number of shares released for year (20,000) multiplied by the cost per share to employee stock ownership plan ($10).

(3) Total number of shares released for year (20,000) multiplied by the difference between average fair value per share (see the table in [f] of the preceding paragraph) and cost per share to employee stock ownership plan ($10). [Year 1: 20,000 shares multiplied by ($10.75-$10.00)]

(4) Cumulative number of allocated shares (see the table in [k] of the preceding paragraph) multiplied by the dividend per share. [Year 2: 20,000 shares multiplied by $.50]

(5) Number of shares released for compensation (see the table in [i] of the preceding paragraph) multiplied by the average fair value per share for the period (see the table in [f] of the preceding paragraph). The amounts in this column have been rounded.

(6) The cash disbursed each year is comprised of $213,800 contribution and $50,000 in dividends.

55-8 The following tables set forth Entity A's tax (assuming no termination) and earnings per share (EPS) computations.

	Year				
	1	2	3	4	5
Income before employee stock ownership plan	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(215,000)	(195,000)	(170,000)	(190,000)	(224,000)
Pretax income	1,485,000	1,621,400	1,764,400	1,864,200	1,952,000
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Total	600,000	646,560	693,760	741,680	790,400
Net income	$885,000	$974,840	$1,070,640	$1,122,520	$1,161,600
Average shares outstanding	1,010,000	1,030,000	1,050,000	1,070,000	1,090,000
Earnings per share	$ .88	$ .95	$1.02	$1.05	$1.07

• • > Case C: A Convertible-Preferred-Stock Leveraged Employee Stock Ownership Plan with a Direct Loan

55-21 This Case illustrates a convertible preferred stock leveraged employee stock ownership plan with a direct loan. On January 1, Year 1, Entity D established an employee stock ownership plan with convertible preferred stock. The assumptions are as follows:

a. The borrowing, debt service, earnings, and tax assumptions are the same as those for Entity A outlined in Case A.
b. On January 1, Year 1, the employee stock ownership plan used the proceeds of the debt to buy 80,000 shares of newly issued convertible preferred stock of Entity D for $12.50 per share.
c. The preferred stock pays dividends quarterly at an annual rate of $1.25 per share ($100,000 each year for the employee stock ownership plan shares). Accordingly, in this Case the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
d. All dividends on employee stock ownership plan shares are used for debt service.
e. The preferred stock is convertible into common stock at 1:1 ratio.
f. Participants may not withdraw the convertible preferred stock from the employee stock ownership plan. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
g. The preferred stock has a guaranteed minimum redemption value of $12.50 per share, to be paid in shares of common stock.
h. The preferred stock is callable at $13.00 per share.
i. There is one vote per preferred share.
j. The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow.

Year	Year-End	Average
1	$12.50	$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

55-22 The shares released each year follow.

Year	Dividends	Compensation	Total Released	Total Allocated
1	0	16,000	16,000	0
2	1,600	14,400	16,000	16,000
3	3,200	12,800	16,000	16,000
4	4,800	11,200	16,000	16,000
5	6,061	9,939	16,000	16,000

55-23 Note that the number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (16,000 multiplied by $1.25 in Year 2; 32,000 multiplied by $1.25 in Year 3; and so forth) by the average fair value of a share of preferred stock ($12.50 in Years 2 and 3). In this illustration the remaining shares are released for compensation (16,000 less 1,600 in Year 2, 16,000 less 3,200 in Year 3, and so forth).

55-24 Additional share information follows.

	Cumulative Number of Shares		
Year	*Released*	*Allocated*	Year-End Suspense *Shares*
1	16,000	0	64,000
2	32,000	16,000	48,000
3	48,000	32,000	32,000
4	64,000	48,000	16,000
5	80,000	64,000	0

55-25 The following chart sets forth Entity D's employee stock ownership plan related information. All amounts represent changes (credits in parentheses) in account balances.

Year	*Principal*	*Unearned Employee Stock Ownership Plan Shares*	*Paid-In Capital*	*Dividends*	*Interest Expense*	*Compensation Expense*	*Cash*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(5)*	*(6)*
1	$163,800	$(200,000)	$ -	$ -	$100,000	$200,000	$(263,800)
2	180,200	(200,000)	-	20,000	83,600	180,000	(263,800)
3	198,200	(200,000)	-	40,000	65,600	160,000	(263,800)
4	218,000	(200,000)	-	60,000	45,800	140,000	(263,800)
5	239,800	(200,000)	(11,200)	80,000	24,000	131,200	(263,800)
Total	$1,000,000	$(1,000,000)	$(11,200)	$200,000	$319,000	$881,200	$(1,319,000)

Notes:
(1) See the table in paragraph 718-40-55-4(h).
(2) Total number of shares released during the year (16,000) multiplied by the cost per share to employee stock ownership plan ($12.50).
(3) Total number of shares released during the year (16,000) multiplied by the difference between average fair value per share at the release date (see the table in paragraph 718-40-55-21[j]) and cost-per-share to the employee stock ownership plan ($12.50).
(4) Cumulative shares allocated (see the table in the preceding paragraph) multiplied by the dividend per share ($1.25).
(5) Total number of employee stock ownership plan shares released for compensation (see the table in paragraph 718-40-55-22) multiplied by the average fair value per share to employee stock ownership plan (see the table in paragraph 718-40-55-21[j]).
(6) The cash disbursed each year is composed of $163,800 in contributions and $100,000 in dividends.

55-27 The tax and EPS calculations for Entity D follow.

	Year				
	1	*2*	*3*	*4*	*5*
Income before employee stock ownership plan	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(200,000)	(180,000)	(160,000)	(140,000)	(131,200)
Pretax income	1,500,000	1,636,400	1,774,400	1,914,200	2,044,800
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920

Total	$600,000	$646,560	$693,760	$741,680	$790,400
Net income	$900,000	$989,840	$1,080,640	$1,172,520	$1,254,400
Preferred stock dividends	-	20,000	40,000	60,000	80,000
Earnings applicable to common stock	$900,000	$969,840	$1,040,640	$1,112,520	$1,174,400
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Basic EPS without conversion	$ .90	$ .97	$1.04	$1.11	$1.17
Diluted EPS if converted	$ .89	$ .95	$1.01	$1.07	$1.13

55-28 If-converted computation.

	Year				
	1	2	3	4	5
Earnings applicable to common stock	$900,000	$969,840	$1,040,640	$1,112,520	$1,174,400
Add—					
Preferred dividends net of tax	-	12,000	24,000	36,000	48,000
Tax benefit on as if converted common dividend (1)	-	3,902	8,421	10,909	12,800
Less—					
Additional compensation (2)	-	(6,146)	(11,368)	(19,636)	(28,800)
Adjusted earnings	$900,000	$979,596	$1,061,693	$1,139,793	$1,206,400
Shares outstanding					
Non-employee stock ownership plan	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Employee stock ownership plan as if converted (3)	9,302	29,268	52,632	63,636	72,000
Total	1,009,302	1,029,268	1,052,632	1,063,636	1,072,000
If-converted diluted EPS	$ .89	$ .95	$1.01	$1.07	$1.13

55-29 Computations for (1), (2), and (3) follow.

	Year				
	1	2	3	4	5
(1) Allocated preferred shares	0	16,000	32,000	48,000	64,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted allocated common shares	0	19,512	42,105	54,545	64,000
Dividends at $.50 per common share	$ -	$9,756	$21,053	$27,273	$32,000

Tax benefit on common dividends	$ -	$3,902	$8,421	$10,909	$12,800
(2) Preferred dividends at $1.25 per share	$ -	$20,000	$40,000	$60,000	$80,000
Dividends at $.50 per common share	$ -	(9,756)	(21,053)	(27,273)	(32,000)
Additional compensation gross	$ -	$10,244	$18,947	$32,727	$48,000
Net of tax	$ -	$6,146	$11,368	$19,636	$28,800
(3) Computation average preferred shares released	8,000	24,000	40,000	56,000	72,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted average released common shares	9,302	29,268	52,632	63,636	72,000

			Year		
	1	2	3	4	5
Pretax income	$1,500,000	$1,636,400	$1,774,400	$1,914,200	$2,044,800
Tax at 40 percent (statutory rate)	$600,000	$654,560	$709,760	$765,680	$817,920
Benefit of employee stock ownership plan dividends	-	(8,000)	(16,000)	(24,000)	(32,000)
Effect of difference between fair value and cost of released shares	-	-	-	-	4,480
Provision as reported	$600,000	$646,560	$693,760	$741,860	$790,400

• > Example 2: A Convertible, Preferred-Stock, Leveraged Employee Stock Ownership Plan Used to Fund a 401(k) Savings Plan with an Employer Loan

55-30 This Example illustrates the guidance in paragraphs 718-40-25-7 through 25-17; 718-40-30-1 through 30-4; 718-40-35-1; 718-40-40-1 through 40-7; and 718-40-45-3 through 45-8 for a convertible preferred stock leveraged employee stock ownership plan used to fund a 401(k) savings plan with an **employer loan**. This Example has the following assumptions:

a. On January 1, Year 1, Entity E established a leveraged employee stock ownership plan with convertible preferred stock.
b. The employee stock ownership plan borrowed $1,000,000 from the employer at 10 percent for 5 years and used the proceeds to buy 80,000 shares of newly issued convertible preferred stock of Entity E for $12.50 per share.
c. Debt service is funded by cash contributions and dividends on employer stock held by the employee stock ownership plan.
d. Dividends on all of the original 80,000 shares held by the employee stock ownership plan are used for debt service.
e. Cash contributions are made at the end of each year.
f. The preferred stock pays dividends quarterly at an annual rate of $1.25 per share ($100,000 each year for the employee stock ownership plan's

shares). Accordingly, in this Example, the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.

g. The preferred stock is convertible at a 1:1 ratio into common stock.
h. Participants may not withdraw the convertible preferred stock from the employee stock ownership plan. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
i. The preferred stock has a guaranteed minimum redemption value of $12.50 per share, to be paid in shares of common stock.
j. The preferred stock is callable at $13.00 per share.
k. There is one vote per preferred share.
l. The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow.

Year	Year-End	Average
1	$12.50	$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

m. Entity E uses shares released by the employee stock ownership plan to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The fair value of the shares at the end of each month is used to determine the number of shares necessary to satisfy the matching obligation. (Accordingly, in this Example, average fair values are used to determine the number of shares needed to satisfy the employer's liabilities.)
n. If the fair value of the shares released is less than Entity E's matching obligation, Entity E contributes additional newly issued shares (top-up shares) to the employee stock ownership plan to satisfy the remaining obligation. The top-up shares are issued at the end of the year. Dividends on the top-up shares are paid in cash.
o. Shares that replace dividends on allocated shares used to service debt do not count toward the employer's match.
p. The employee contributions, required employer match, and the number of shares needed to fund the employee match follow.

Year	Employee Contributions	Employer Match	Number of Shares
1	$400,000	$200,000	16,000
2	410,000	205,000	16,400
3	420,000	210,000	16,800
4	430,000	215,000	17,200
5	440,000	220,000	16,667

Note that the number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock (for Year 1: $200,000 divided by $12.50 equals 16,000 shares).

q. Principal and interest are payable in annual installments at the end of each year. Debt service is as follows.

Year	Principal	Interest	Total Debt Service
1	110,000	$100,000	$210,000
2	150,000	89,000	239,000
3	200,000	74,000	274,000
4	250,000	54,000	304,000
5	290,000	29,000	319,000
Total	$1,000,000	$346,000	$1,346,000

r. Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participants' accounts at the beginning of the following year. Shares are assumed to be released ratably throughout the year.

s. The shares released each year follow.

Year	Number of Shares Needed to Satisfy 401(k) Liability	Total Released	Shares Released for Dividends	Employee Stock Ownership Plan Shares Available to Satisfy 401(k) Liability	Additional Shares (Top-Up)
1	16,000	12,481	0	12,481	3,519
2	16,400	14,205	1248	12,957	3,443
3	16,800	16,286	2669	13,617	3,183
4	17,200	18,068	4297	13,771	3,429
5	16,667	18,960	5780	13,180	3,487

Note that the number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (12,481 multiplied by $1.25 in Year 2; 26,686 multiplied by $1.25 in Year 3, and so forth) by the average fair value of a share of preferred stock ($12.50 in Years 2 and 3). In this example, the remaining shares are released for compensation (14,205 less 1,248 in Year 2; 16,286 less 2,669 in Year 3, and so forth).

t. Additional share information follows.

	Initial Employee Stock Ownership Plan Shares		Top-Up Shares				
	Cumulative Shares		Cumulative Shares				
Year	Released	Allocated	Issuable	Issued	Average Shares Released or Issuable	Total Shares Allocated	Year-End Suspense Shares
1	12,481	0	3,519	0	8,000	0	67,519
2	26,686	12,481	6,962	3,519	24,824	16,000	53,314
3	42,972	26,686	10,145	6,962	43,383	33,648	37,028
4	61,040	42,972	13,574	10145	63,866	53,117	18,960
5	80,000	61,040	17,061	13574	85,838	74,614	0

u. The pre-employee stock ownership plan income, shares outstanding, and income tax assumptions are the same as for Example 1 (see paragraph 718-40-55-3).

55-31 The following chart sets forth Entity E's employee stock ownership plan related information. All amounts represent changes (credits are in parentheses) in account balances.

Year	*Unearned Employee Stock Ownership Plan Shares*	*Paid-In Capital*	*Dividends—Original Shares*	*Dividends Top-Up Shares*	*Compensation Expense Employee Stock Ownership Plan*	*Compensation Expense Top-Up*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1	$(156,000)	$(44,000)	$ -	$ -	$156,000	$44,000
2	(177,600)	(43,000)	15,600	4,400	162,000	43,000
3	(203,600)	(39,800)	33,400	8,700	170,200	39,800
4	(225,800)	(42,900)	53,700	12,700	172,100	42,900
5	(237,000)	(59,300)	76,300	17,000	174,000	46,000
Total	$(1,000,000)	$(229,000)	$179,000	$42,800	$834,300	$215,700

Notes:

(1) Total number of shares released during the year multiplied by the cost per share to employee stock ownership plan ($12.50).

(2) Total number of shares released during the year multiplied by the difference between average fair value per share at the release date (see the table in [l] of the preceding paragraph) and cost per share to the employee stock ownership plan ($12.50) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the employee stock ownership plan.

(3) Cumulative shares allocated from original 80,000 shares (see the table in [t] of the preceding paragraph) multiplied by the dividend per share ($1.25).

(4) Cumulative top-up shares issued (see the table in [t] of the preceding paragraph) multiplied by the dividend per share ($1.25).

(5) Total number of employee stock ownership plan shares released for compensation (see the table in [s] of the preceding paragraph) multiplied by the average fair value per share (see the table in [l] of the preceding paragraph).

(6) Top-up shares (see the table in [s] of the preceding paragraph) multiplied by the average fair value per share (see the table in [l] of the preceding paragraph).

55-33 The tax and earnings per share (EPS) computations for Entity E follow.

			Year		
	1	*2*	*3*	*4*	*5*
Income before employee stock ownership plan	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	100,000	89,000	74,000	54,000	29,000
Compensation—employee stock ownership plan	156,000	162,000	170,200	172,100	174,000
Compensation—top-up	44,000	43,000	39,800	42,900	46,000
Pretax income	1,500,000	1,606,000	1,716,000	1,831,000	1,951,000
Provision for income tax					
Currently payable [KPMG Note 1]	618,400	647,200	674,480	701,240	734,000

Deferred	(18,400)	(11,040)	(1,440)	9,680	21,200
Total	600,000	636,160	673,040	710,000	755,200
Net income	900,000	969,840	1,042,960	1,120,080	1,195,800
Preferred stock dividends	-	20,000	42,100	66,400	93,300
Earnings applicable to common stock	$900,000	$949,840	$1,000,860	$1,053,680	$1,102,500
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Basic EPS without conversion	$0.90	$0.95	$1.00	$1.05	$1.10
Diluted EPS if converted	$0.89	$0.93	$0.97	$1.01	$1.06

			Year		
	1	*2*	*3*	*4*	*5*
Earnings applicable to common shares	$900,000	$949,840	$1,000,860	$1,053,680	$1,102,500
Add—					
Preferred dividends net of tax	-	12,000	25,260	39,840	55,980
Tax benefit on as-if converted common dividend (1)	-	3,902	8,855	12,072	14,923
Less—					
Additional compensation (2)	-	4,795	9,481	17,579	27,468
Adjusted earnings	$900,000	$960,947	$1,025,494	$1,088,013	$1,145,935
Shares outstanding non-employee stock ownership plan	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Employee stock ownership plan as if converted (3)	9,302	30,273	57,083	72,575	85,838
Total	1,009,302	1,030,273	1,057,083	1,072,575	1,085,838
If-converted diluted EPS	$0.89	$0.93	$0.97	$1.01	$1.06

			Year		
	1	2	3	4	5
Calculation 1:					
Allocated and issued preferred shares	0	16,000	33,648	53,117	74,614
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If-converted allocated and issued common shares	0	19,512	44,274	60,360	74,614
Dividends at $.50 per common share	$ -	$9,756	$22,137	$30,180	$37,307
Tax benefit on common dividends	$ -	$3,902	$8,855	$12,072	$14,923

Calculation 2:					
Allocated preferred shares (excluding top-up shares)	0	12,481	26,686	42,972	61,040
Preferred dividends at $1.25 per share	$ -	$15,601	$33,358	$53,715	$76,300
If-converted allocated common shares (excluding top-up shares)	0	15,221	35,113	$48,832	$61,040
Dividends at $.50 per common share	$ -	$7,610	$17,557	$24,416	$30,520
Additional compensation gross	$ -	$7,991	$15,801	$29,299	$45,780
Net of tax	$ -	$4,795	$9,481	$17,579	$27,648
Calculation 3:					
Average preferred shares released and issuable	8,000	24,824	43,383	63,866	85,838
If-converted average released and issuable common shares	9,302	30,273	57,083	72,575	85,838

KPMG Note:

1. The amount for this item is blank in paragraph 260-10-55-33; however that was a typographical error. Therefore, we have edited the example to include the correct amount.

6.20 Employee stock purchase plans

6.20.10 Overview of the instrument

Many entities sponsor ESPPs, which allow employees to purchase the entity's shares at a discount. For example, a plan may give employees the right to purchase shares at 85% of the lesser of (1) the share's market price on the first day (grant date) or (2) the last date (purchase date) of a six-month enrollment period (a 'look-back' arrangement). Employees may elect to have amounts withheld from their paycheck, subject to certain limitations, to fund the purchase of the shares. If an employee elects not to purchase the shares, the amount withheld from the employee's paycheck during the six-month period is refunded to the employee.

Chapter 11 of KPMG Handbook, Share-based payment, discusses the accounting for ESPPs.

6.20.20 EPS implications

Subtopic 718-50 discusses ESPPs. Shares issued under ESPPs are outstanding shares and are included in the calculation of basic and diluted EPS. Topic 260 does not specifically address the ESPP considerations for diluted EPS for shares that are not yet purchased, but for which the cash for purchasing the ESPP shares has already been withdrawn from the employees' accounts. However, FTB 97-1 refers to the contingently issuable shares guidance in paragraphs 260-10-45-48 to 45-57 to be applied to ESPPs when calculating diluted EPS. For

ESPPs, the contingency is the amount of payroll withheld during the offering period and the contingency is not met until the respective shares are purchased. The withholdings would be classified as a deposit liability of the entity until the contingency is settled in cash or shares. [FTP 97-1 FN1]

The treatment in basic and diluted EPS calculations for an ESPP may depend on whether the amounts currently available to purchase shares are refundable to the employee.

When the amount is refundable

When the amount is refundable, the substance of the plan is that the employee is being issued an option each pay period or each time a contribution is made to the plan. Therefore, the shares currently purchasable are not included in the weighted-average shares outstanding in the calculation of basic EPS.

However, dilution is determined for diluted EPS using the treasury stock method as follows.

1. Amounts withheld from or contributed by the employees are assumed to be used to purchase shares at the plan price (this increases the number of shares in the denominator).
2. The entity is assumed to use the proceeds received in (1) to buy treasury stock at the average market price; this decreases the number of shares in the denominator. Assumed proceeds equal employee contributions plus unearned compensation.

Assumed total employee contributions + **Average unrecognized compensation cost** = **Total proceeds received to purchase ESPP shares**

When the amount is not refundable

When the amount withheld from or contributed by employees to purchase the shares under the plan is not refundable, the shares currently purchasable by the employee are included in basic EPS and also diluted EPS. The number of shares currently purchasable is determined using the plan price.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator ✓	Numerator X Denominator X / ✓
Shares held in an ESPP are considered oustanding from the date purchased and included in basic EPS on a weighted-average basis.	When the amount contributed into the ESPP is refundable, in the diluted EPS calculation shares not yet purchased for ESPPs are treated as options, using the treasury stock method (see section 6.9); this is because the ESPPs represent potential common shares. The weighted-average shares outstanding is based on

Potential effect on basic EPS	Potential effect on diluted EPS
	the number of shares that would be issuable at the end of the reporting period if it were the end of the purchase period, based on the amounts withheld by the entity to date. The assumed proceeds under the treasury stock method are calculated based on the sum of (1) cash assumed to be received over the course of the offering period, including cash received to date that is recorded as a deposit liability on the issuer's balance sheet, and (2) the average unearned compensation cost related to the plan during the period. The total assumed proceeds are divided by the average stock price for the reporting period to determine the hypothetical number of shares that can be repurchased under the treasury stock method. See Example 6.9.40 for an illustration of the treasury stock method including unearned compensation.
Dilutive or antidilutive? Shares underlying the funds held by an ESPP are dilutive.	

6.20.30 Interpretive analysis and examples

Question 6.20.10

How are shares under a nonrefundable ESPP included in basic and diluted EPS?

Background: ABC Corp. offers all eligible employees the right to purchase annually its common shares at a 15% discount from market price. Under the terms of the ESPP, the employee has no ability to obtain a refund for the compensation withheld.

Interpretive response: For these shares there is no contingency to be considered because the amounts withheld to purchase the stock are not refundable. Therefore, basic and diluted EPS reflect as outstanding in the denominator the number of shares issuable based on the amount withheld to date. In this situation, there is no adjustment to the numerator for either basic or diluted EPS.

Question 6.20.20

How are 'look-back' options in an ESPP accounted for in diluted EPS?

Background: 'Look-back' options typically have a variable exercise price. For example, they may have an exercise price that is 90% of the lower of the grant-date share price or the purchase-date share price.

Interpretive response: When calculating diluted EPS for look-back options at the end of a reporting period, the entity calculates the incremental shares from look-back options based on the price the employees would pay to exercise the options at the reporting date. In the background example, this means that the employer assumes the reporting date is the share purchase date and compares the share price on that date to the grant-date share price.

Example 6.20.10

Diluted EPS for an ESPP

ABC Corp. has 1,500,000 shares of common stock outstanding on January 1, Year 1. On October 1, Year 1, when the stock price is $50, ABC offers its employees the opportunity to sign up for a payroll deduction to purchase its stock at the lower of 85% of the stock's current price or 85% of the stock price at the end of a six-month offering period ending on March 31, Year 2. Therefore, the exercise price of the look-back options is the lesser of (1) $42.50 ($50 × 85%) or (2) 85% of the stock price at the end of the period when the option is exercised.

Payroll deductions are refundable through the end of the offering period.

The following information is also relevant.

— Market price of ABC's stock on December 31, Year 1 is $40.
— Average share price for the period from October 1, Year 1 to December 31, Year 1 is $44.
— Employee withholding at December 31, Year 1 totals $3,500,000.
— Expected withholdings for the remaining offering period, based on current employee elections, is $3,300,000.
— Net income for Year 1 is $2,700,000.

EPS calculations – Year 1

EPS at a glance

	Basic	Diluted
Numerator	$2,700,000	$2,700,000
Denominator	1,500,000	1,500,000
EPS	$1.80	$1.80

Basic EPS

1 Determine the numerator

No adjustment is necessary. The numerator is $2,700,000.

2 Determine the denominator

There is no change in the number of outstanding shares during the year because the structure is a refundable plan. Therefore, the denominator is 1,500,000.

3 Determine basic EPS

Basic EPS = $2,700,000 ÷ 1,500,000 = $1.80

Diluted EPS

1 Identify potential common shares

Based on the structure of this ESPP, shares issuable under the ESPP are potential common shares starting when the ESPP shares are granted, and are treated as equivalent to options until the shares are issued.

2 For each potential common share, calculate EPIS

Potential adjustment to the numerator for EPIS: No adjustment is required because these are treated as options.

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows.

Step i	Weighted-average number of shares to be issued under the ESPP[1]	50,000	(A)
	Exercise price[1]	$34	(B)
	Future services[2]	$1,560,000	(C)
	Assumed proceeds	**$3,260,000**	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares[2]	$44	(E)
	Number of common shares deemed repurchased	**74,090**	(F) = (D) ÷ (E)
Step iii	Weighted-average estimated shares to be issued under ESPP[1]	50,000	(G)
	Incremental shares	**(24,090)**[3]	(G) – (F)

Notes:

1. Expected total withholdings of $6,800,000 ($3,500,000 + $3,300,000) + $34 ($40 × 85%, the lesser of the stock price at the beginning of the offering period or at the reporting date, per purchase price formula) = 50,000 weighted-average shares assumed issued (October 1 – December 31 is 25% of the year (25% × 200,000 = 50,000 ESPP weighted average shares outstanding)).
2. For illustrative purposes, in this example the average share price during the reporting period (October 1, Year 1 to December 31, Year 1) is $44 and the average unrecognized compensation cost for the plan for the reporting period ended December 31, Year 1 is assumed to be $1,560,000. For additional guidance on the calculation of average unrecognized compensation cost, see Example 6.9.50.

   Unrecognized compensation cost at beginning of year: 1,000,000 × $1.00 = $1,000,000
3. Because the number of shares deemed repurchased exceeds the weighted-average estimated shares to be issued, there are no incremental shares included in diluted EPS.

3 Rank the potential common shares

This step does not apply, because the ESPP shares are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.80 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

Applying the treasury stock method results in a negative number of incremental shares. Therefore, the effect is antidilutive. Diluted EPS is the same as basic EPS.

Diluted EPS = $1.80

6.21 EPS for instruments in SPAC transactions

6.21.10 Overview of the instruments

Generally, SPACs are newly formed companies initially capitalized with nominal funds (to cover the initial expenses) by a management team or sponsor, that then raise additional cash through an IPO. After completing its IPO, a SPAC looks to identify and complete a merger with a target operating company (target).

The SPAC may require additional financing to complete the merger and often identifies PIPE (private investment in public equity) investors to provide additional capital. Generally, those PIPE investors are either affiliated with the SPAC sponsor or third-party institutional investors.

Once the SPAC's public shareholders approve the merger, the transaction closes, and the target becomes a public entity (post-merger registrant). When the transaction results in a reverse recapitalization, in which the target company is the accounting acquirer, the process of consummating the transaction is referred to as the 'de-SPAC' process.

Financial instruments commonly issued during the SPAC lifecycle include:

— founder's shares (also known as sponsor's shares);
— IPO shares;
— private warrants;
— public warrants; and
— earn-out shares.

Shares and warrants may also be subject to renegotiation throughout the SPAC lifecycle.

Some of the instruments may include various features, including redemption features, which affect their accounting classification and corresponding measurement as either equity, temporary equity or liabilities.

See the KPMG SPAC Intel Hub for more information on SPACs.

6.21.20 EPS implications

Instruments issued as part of a SPAC transaction give rise to various EPS questions, during both the SPAC and de-SPAC processes. Topic 260 does not address all issues related to SPACs, but general guidance for these questions can be found in this Handbook as follows.

Question	Reference
Is the instrument a participating security?	Section 5.2
How are earnings (losses) allocated?	Section 5.3 Section 5.4 Section 5.5
How are conditions evaluated in instruments to determine if they should be included in basic and diluted EPS?	Section 6.10
How are cash-settlement/redemption features evaluated?	Section 6.13
How does the mark-to-market adjustment of liability-classified instruments affect diluted EPS?	Section 6.13.20 Section 6.13.30

Question	Reference
How does remeasurement of temporary equity affect EPS?	Question 3.3.20[1]
How is EPS of the de-SPAC entity presented?	Section 7.5

Note:

1. Depending on the terms of the SPAC transaction, diversity in practice exists for how the remeasurement of temporary equity affects EPS.

Additional guidance and examples can be found in Chapter 7 of KPMG Handbook, Consolidation.

7. Retrospective adjustments

Detailed contents

7.1 How the standard works

EPS for comparative periods is retrospectively adjusted in the following circumstances.

Stock dividend, stock split, reverse stock split (see section 7.3)	Retrospectively adjust denominator to reflect the weighted-average number of shares outstanding after the event.
Rights issue (see section 7.4)	Retrospectively adjust denominator for the bonus element based on prescribed formula.
Reverse acquisitions and reorganizations (see section 7.5)	Retrospectively adjust numerator and denominator based on prescribed formula.
Accounting changes retrospectively applied and error corrections (see section 7.6)	Retrospectively adjust numerator to reflect accounting change or correction (adjust denominator if necessary).

7.2 Why retrospective adjustments?

7.2.10 Overview

Generally, the number of outstanding common shares or potential common shares used in the denominator for basic and diluted EPS calculations is the weighted average for a reporting period. Weighted-average amounts are used so that the effect of increases or decreases during a period is related only to the portion of the period during which the related resources are available for use in an entity's operations.

Some changes to the capital structure of an entity (e.g. stock dividend, stock split, reverse stock split) result in a change in the number of outstanding common shares. However, these changes do not come with a corresponding change in the entity's resources or capital base. In these cases, using a weighted-average number of outstanding common shares in the EPS calculation may not appropriately reflect the change in the entity's earnings capacity.

Topic 260 requires the denominator for basic and diluted EPS to be retrospectively adjusted for such events to more appropriately reflect an entity's earnings capacity and to enhance comparability over time. The adjustment is made for such an event during the reporting period the event occurs and for all prior periods presented. However, the conversion of potential common shares does not give rise to a retrospective adjustment. [260-10-55-12]

Question 7.2.10

Why do conversions of potential common share instruments not require retrospective adjustment?

Interpretive response: Converting potential common shares into common shares (e.g. stock option exercise) does not usually require a retrospective adjustment to basic EPS. This is because potential common shares are usually issued for consideration, resulting in a change in the resources available to the entity. Additionally, the exercise or conversion of potential common shares results in a change to existing owners' relative residual interest in the entity, whereas stock dividends, stock splits, etc., do not. Accordingly, the resulting common shares are dealt with in the denominator from the date on which the shares become outstanding, without any retrospective adjustment (see sections 3.4 and 4.4.40). [FRM 3430.1]

Similarly, diluted EPS is not retrospectively adjusted for:

- subsequent conversions of potential common shares; or
- any subsequent changes in the assumptions made in determining the dilutive effects of potential common shares, such as whether contingently issuable shares would be issued (see section 6.10.20).

7.2.20 When retrospective adjustment of EPS applies

Retrospectively adjusting EPS amounts for a stock dividend (as in Example 7.3.10), stock split or reverse stock split appears intuitive. However, the principle has a wider application – applying to other changes in an entity's capital structure, and when there is a retrospective correction of an error or retrospective application of accounting policies during a reporting period. Additional considerations on various transactions or accounting changes are addressed in the rest of this section.

Retrospective adjustments	Stock dividends, stock splits and reverse stock splits (share consolidation)	Section 7.3
	Rights issue	Section 7.4
	Reverse acquisition (under Subtopic 805-40) and reorganizations (under Subtopic 805-50)	Section 7.5
	Prior-period adjustments – retrospective correction of errors or retrospective application of accounting principles	Section 7.6

These are the only changes specifically mentioned in Topic 260 that require retrospective adjustment. EPS is not retrospectively adjusted for any other changes in capital structure. However, the effects of any other changes in capital structure on EPS may be disclosed in the notes to the financial statements. For example, if an entity issues a new class of stock or a tracking stock, this change is presented prospectively (see also section 7.3.30). [260-10-55-12 – 55-13, 55-15 – 55-17]

Observation

Retrospective EPS adjustment for capital structure changes vs for restatements and new accounting principles

There is a distinction between the retrospective EPS adjustments for a change in capital structure (stock dividend, stock split, reverse stock split), and a retrospective adjustment for a restatement or upon initial application of a change in accounting principle. The former results in a change to the weighted-average number of shares outstanding (i.e. the denominator) only. The latter generally results in a change to the income available to common shareholders (i.e. the numerator) (see section 7.6.10).

7.3 Stock dividends, stock splits and reverse stock splits

Excerpt from ASC 260-10

• • > Stock Dividends or Stock Splits

55-12 If the number of common shares outstanding increases as a result of a **stock dividend** or stock split (see Subtopic 505-20) or decreases as a result of a reverse stock split, the computations of basic and diluted EPS shall be adjusted retroactively for all periods presented to reflect that change in capital structure. If changes in common stock resulting from stock dividends, stock splits, or reverse stock splits occur after the close of the period but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the per-share computations for those and any prior-period financial statements presented shall be based on the new number of shares. If per-share computations reflect such changes in the number of shares, that fact shall be disclosed.

7.3.10 Overview

Equity restructurings such as stock dividends, stock splits and reverse stock splits are effectively a redenomination of shares. They increase or decrease the number of an entity's common shares outstanding without a corresponding change in the entity's resources.

When these capital events have occurred during a reporting period, retrospective adjustment to the denominator for EPS better reflects an entity's performance on a per-share basis over time. Specifically, this involves adjusting the number of common shares outstanding before the event for the proportionate change in the number of common shares outstanding, as if the change had occurred at the beginning of the earliest period presented.

This approach applies regardless of whether the event occurred during the period or after the period but before the financial statements are issued (available to be issued) because such events are treated as recognized subsequent events. [260-10-55-12, 505-10-S99-4]

Observation

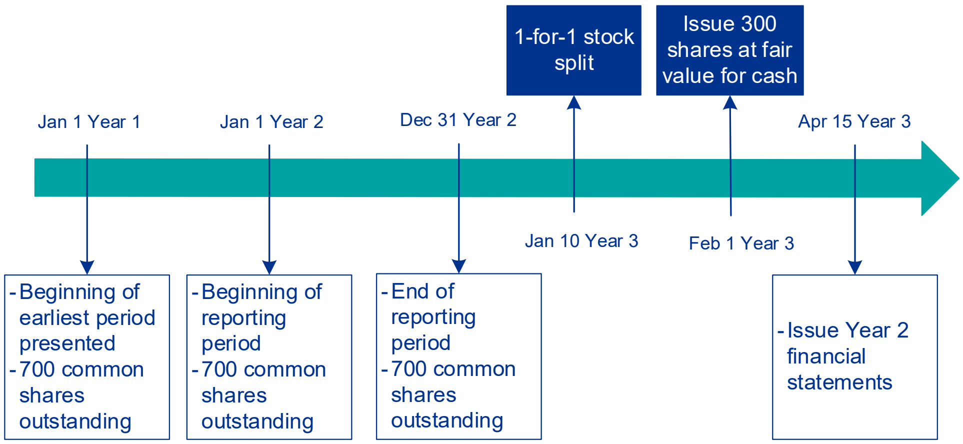
Stock split and stock dividend accounting models

A stock dividend is accounted for by transferring the fair value of the additional shares from retained earnings to common stock (at par value) and additional paid in capital. A stock split does not require an adjustment to retained earnings. However, both transactions require a retrospective adjustment to the EPS calculation.

Example 7.3.10

Stock split after the reporting date but before the financial statements are issued

The following timeline shows details of ABC Corp.'s common shares over a period.



ABC needs to analyze the two stock transactions that occurred in January and February of Year 3.

Issue of 300 shares

The 300 common shares issued by ABC on February 1 of Year 3 are for cash at fair value. Accordingly, the resulting increase in the number of common shares comes with a corresponding increase in resources, and the increase is included in the denominator only from the date on which the consideration is received (see section 3.4.20). Therefore, these shares are not included in the denominator for basic EPS for Year 2 or earlier.

Stock split

The 700 shares issued on January 10 of Year 3 increase the number of outstanding common shares of ABC without any corresponding change in resources. Accordingly, ABC's basic and diluted EPS amounts for both the current (Year 2) and the comparative (Year 1) period are adjusted retrospectively, as if the stock split had occurred from the beginning of the earliest period presented – i.e. January 1 of Year 1. In other words, 1,400 shares are used in the denominator for both Year 2 and Year 1.

Question 7.3.10

If a stock dividend, stock split or reverse stock split occurs after the reporting date, what is the trigger date for retrospective adjustment of EPS?

Interpretive response: Topic 260 requires that an entity retrospectively adjust financial statements to include the effects of a post-reporting date stock dividend, stock split or reverse stock split if it occurs before the financial statements are issued (available to be issued). [260-10-55-12, 505-10-S99-4]

For determining at what date retrospective adjustment is required, it makes no difference whether the dividend or split was declared before or after the reporting date, but rather when it occurs. We believe a stock dividend, stock split or reverse stock split occurs on the ex-dividend date; that is when the entity knows the quantity of shares affected by the event and the market reflects the adjusted per-share price.

However, for greater than 25% distributions, the record date comes before the ex-dividend date. Because the quantity of shares and who will receive them is known on the record date in this instance, we believe the SEC staff would not object to use of the record date as the trigger date for greater than 25% distributions.

When the stock dividend, stock split or reverse stock split is declared before the issuance of the financial statements but does not occur until after their issuance, the entity provides disclosure of its effects, generally through a pro forma disclosure of the transaction in the notes to its financial statements. See section 9.2.30. [855-10-50-2, S-X Article 11-01]

Question 7.3.20

If a distribution may be received in shares or in cash, is retrospective EPS adjustment required?

Background: Sometimes an entity (e.g. a REIT) will distribute a fixed dollar amount to its shareholders with the option to receive their entire distribution in cash or shares of equivalent value with a potential limitation on the total amount of cash that shareholders can elect to receive in the aggregate – e.g. for tax reasons or legal authorization requirements.

Interpretive response: No. Topic 505 clarifies that a distribution that contains components of cash and stock and that allows shareholders to elect to receive cash or shares with a potential limitation on the total amount that all shareholders can elect to receive in the aggregate is considered a share issuance. In this case, the entity should follow the guidance in Subtopic 480-10 and account for the distribution as a liability and include the potential settlement in shares in the dilutive EPS calculation using the guidance in paragraphs 260-10-45-45 to 45-47 until the liability is settled. See also Question 5.3.50. [505-20-15-3A]

Question 7.3.30

If an exchange ratio is used in a mutual holding company conversion, should EPS be presented prospectively or retrospectively?

Background: A mutual depository institution may raise capital by converting to a stock institution. This is often done in two steps.

— **First step:** only a portion of the shares are sold to the public.

A mutual depository institution (DI) (owned solely by depositors) raises capital by converting to a stock institution, issuing less than 50% of its shares to the public (original public shares), and forming a mutual holding company (MHC) to hold the remainder of its shares. Depositors of DI indirectly retain majority ownership of DI because they are the owners of the MHC.

— **Second step:** the remaining shares are sold.

The MHC-owned shares of DI are sold to the public to raise additional capital. This is typically accomplished by the formation of a stock holding company (SHC). The MHC transfers its shares in DI to the SHC, which then sells the SHC shares to the public. The original public shares are exchanged for the SHC shares, often using an exchange ratio (e.g. three SHC shares for every one original public share) so that the ownership percentage of the original public shareholders remains constant. After this second-step conversion, the SHC owns 100% of DI, and 100% of the SHC is owned by the public (i.e. no mutual ownership). The MHC is then dissolved.

Interpretive response: We believe that after a second-step conversion when an exchange ratio is used, prior-period EPS should be restated to reflect the fact that the number of previously issued shares (including both the original public shares and the MHC-owned shares) has changed based on the exchange ratio, similar to a stock split. Also see Questions 7.3.50 to 7.3.70.

We also believe that if a mutual insurer uses the same two-step approach, it follows the same guidance.

Question 7.3.40

Should EPS be adjusted retrospectively for the issuance of tracking stock?

Interpretive response: No. This is an example of a change in capital structure that does not result in retrospective adjustment. For the period that includes the issuance of the tracking stock (see Question 2.2.140), the entity's financial statements should report the historical EPS of the entity's single stock up to the date of issuance of the tracking stock, then for each class of stock for the period they were outstanding.

An entity should not account for the creation of the tracking stock capital structure retrospectively because the issuance of tracking stock changes the common shareholders' relative residual interest in the entity. Therefore, the issuance of tracking stock is not treated similar to a stock split. [2000 AICPA Conf]

Question 7.3.50

Should EPS be adjusted retrospectively for a stock split in conjunction with an IPO?

Interpretive response: Yes. It makes no difference when the stock split occurs. Whenever an entity effects a stock split, including upon an IPO, the stock split guidance in Topic 260 applies and EPS is retrospectively adjusted for all periods presented.

Question 7.3.60

Should a Form S-1 be revised for the estimated effect of a reverse stock split before the split occurs?

Background: An entity files an IPO of its common shares and plans to complete a reverse stock split on completion of the offering. Because the reverse stock split will be based on the final proceeds received from the offering, the effect of the reverse stock split is not known at the Form S-1 filing date.

Interpretive response: No. Topic 260 provides specific guidance on the calculation of EPS based on shares outstanding as of the reporting date. Given that the reverse stock split has not yet occurred and the amounts are subject to change, it would not be appropriate to show estimates of share and EPS amounts that reflect the reverse stock split. Upon completion of the reverse stock split, historical financial information is retrospectively adjusted to reflect the reverse stock split for all periods presented. [SEC FRM 3430.1]

However, an entity may provide pro forma EPS information, reflecting the planned reverse stock split.

Question 7.3.70

Can a Form S-1 exclude EPS prior to an IPO, then be revised to include EPS?

Interpretive response: No. Topic 260 requires basic and diluted EPS for an entity with publicly held common shares or potential common shares and for an entity that is in the process of registering shares to sell them to the public. Therefore, the financial statements filed on Form S-1 must include EPS information.

This also would be applicable when an entity has an IPO and the completion of a reverse stock split, in that EPS information is included in the S-1 and historical financial information is presented retrospectively for all periods when the reverse stock split occurs (see Question 7.3.50). However, an entity may provide pro forma EPS information, reflecting the planned reverse stock split.

7.3.20 Retrospectively adjusting the number of potential common shares

The terms and conditions of some potential common shares may contain antidilution provisions that protect their holders from a devaluation of their rights in the event of a stock dividend, stock split or reverse stock split. For example, the terms of a stock option may specify that its conversion ratio be adjusted in the event of a stock split. Therefore, when there is a change in the number of common shares outstanding without a corresponding change in resources such as a stock split, the terms of potential common shares outstanding at the time of the capital event are evaluated to determine whether there is a corresponding change in the number of potential common shares outstanding. If there is a corresponding change, a corresponding retrospective adjustment to the denominator for diluted EPS is required.

Example 7.3.20
Diluted EPS – options with antidilution provisions

ABC Corp.'s income available to its common shareholders is $15,000,000 for both Year 1 and Year 2. During Year 1, the number of common shares outstanding remains unchanged at 1,000,000.

During Years 1 and 2, ABC has the following equity transactions.

— Stock option issuance: on January 1, Year 1, ABC issues 500,000 vested stock options under an equity-settled share-based payment that are exercisable for a fixed price. Each option is exercisable into one common share. The exercise price of the options is $10 which is below the $18 average market price of ABC's common shares for Year 1.

— Stock split: on July 1, Year 2, ABC issues a 1:1 stock split. After the stock split, the market price of ABC's common shares falls to $9 and remains the same for the rest of the year.

The stock options include an antidilution provision such that the exercise price and the number of shares issued on exercise are adjusted automatically for the stock split – i.e. the exercise price per share decreases in proportion to the split (to $5), and each stock option entitles the holder to two shares when it is exercised.

EPS calculations – Year 1 (retrospective)

Year 1 – Retrospective adjustment – Basic EPS

1 Determine the numerator

The numerator is $15,000,000.

2 Determine the denominator

To reflect the decrease in the market price of ABC's common shares, the number of common shares for basic EPS is adjusted.

With retrospective adjustment, the denominator reflects the stock split since the beginning of the earliest period – i.e. the denominator is 2,000,000 for both years.

3 Determine basic EPS

Basic EPS = $15,000,000 ÷ 2,000,000 = $7.50

Year 1 – Retrospective adjustment- Diluted EPS

1 Identify potential common shares

The options are exercisable for more than nominal consideration and are therefore potential common shares for the period during which they are outstanding.

2 For each potential common share, calculate EPIS

The exercise price of the options is below the average market price of ABC's common shares and ABC has earnings available to common stock; therefore, the options are dilutive (see section 6.9.20).

The stock options are equity settled, so there is no potential adjustment to the numerator for EPIS (see section 4.4.30).

Without retrospective adjustment, the denominator for EPIS is calculated using the treasury stock method (see section 6.9.30), as follows.

Step i	Number of options (and shares to be issued on exercise of the options)	500,000	(A)
	Exercise price	$10	(B)
	Assumed proceeds	**$5,000,000**	(C) = (A) × (B)
Step ii	Average market price of common shares	$18	(D)
	Number of common shares deemed to have been repurchased	**277,778**	(E) = (C) ÷ (D)
Step iii	**Bonus element**	**222,222**	(A) – (E)

Because of the antidilution provision, the exercise price is adjusted automatically for the stock split – i.e. the exercise price and the number of shares issued on exercise are adjusted in proportion to the bonus element – and an adjustment is made in determining the bonus element associated with the options. Also, because the terms and conditions provide for an exact proportionate adjustment, the bonus element is adjusted for the same ratio as the weighted-average number of common shares. Therefore, the bonus element for the retrospective adjustment is 444,444 (222,222 × 2). For additional guidance and examples of calculating EPS for instruments with down-round features, see section 6.18.

3 Rank the potential common shares

This step does not apply, because the options are the only class of potential common shares considered.

4 Determine basic EPS from continuing operations

Basic EPS is $7.50 (see Step 3 of basic EPS calculation).

5 Identify dilutive potential common shares and determine diluted EPS

The potential effect of exercise of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$15,000,000	2,000,000	$7.50	
Bonus element	–	444,444		
Total	**$15,000,000**	**2,444,444**	$6.14	✓

Basic and diluted EPS amounts for Year 2 would be the same as Year 1.

Example 7.3.30
Diluted EPS – options without antidilution provisions

Assume the same facts as in Example 7.3.20 except that the terms and conditions of ABC's stock options are that the exercise price of the options or the conversion ratio do not adjust automatically following the stock dividend.

This makes the exercise price of the options ($10) above the average market price ($9) of ABC's common shares for Year 2, and therefore the options are antidilutive for diluted EPS for Year 2. However, the 222,222 bonus shares would still be included in calculating diluted EPS for Year 1.

7.3.30 When a reverse stock split is an in-substance repurchase at fair value

Generally, a reverse stock split does not involve any outflow of resources from an entity, and therefore a retrospective adjustment to EPS is appropriate. However, care is required in determining whether a reverse stock split forms part of an arrangement whose overall effect is a share repurchase at fair value, and for which a retrospective adjustment to EPS is not appropriate.

For example, the substance of a reverse stock split in conjunction with a special dividend may be that of a share repurchase at fair value. If so, the resulting decrease in the number of common shares comes with a corresponding reduction in resources. In this case, when determining EPS the arrangement is treated in accordance with its substance – i.e. the denominator is prospectively (rather than retrospectively) adjusted – from the date on which the special dividend is recognized. This is consistent with the accounting for treasury stock (see section 4.4.40).

An entity that wishes to return surplus capital to its shareholders may achieve its aim in a number of ways, each with different legal or tax implications. When evaluating whether a reverse stock split forms part of an in-substance share repurchase at fair value, a careful evaluation of all relevant facts and circumstances is required. For example, instead of giving a special cash dividend in conjunction with a reverse stock split, an entity may issue a special class of shares to existing shareholders that is redeemable for cash at the option of the holder (with the terms incentivizing a redemption by the holders).

Example 7.3.40

Reverse stock split accompanied by special dividend – in-substance repurchase at fair value

On January 1, Year 1, ABC Corp. has 1,000,000 common shares outstanding. ABC's income available to its common shareholders for Year 1 is $15,000,000.

On October 1 of Year 1, ABC carries out the following transactions to return surplus capital to its shareholders:

- it pays a special dividend of $2 per share in cash to all existing shareholders – i.e. a total of $2,000,000; and
- it carries out a 10:6 reverse stock split, such that the number of outstanding common shares is reduced by 400,000 – i.e. from 1,000,000 to 600,000.
- The market price of ABC's common shares immediately before the special dividend and reverse stock split is $5 per share. There are no other changes in ABC's capital structure during Year 1 and up to the date on which ABC's financial statements are issued.

Basic EPS denominator calculation – Year 1

Although there is a reverse stock split on October 1, Year 1, that reverse stock split is accompanied by a special dividend to shareholders of $2,000,000. This is equal to the sum that ABC would have had to pay to its shareholders if it had directly repurchased the 400,000 shares at fair value instead – i.e. 400,000 shares × $5 per share. Therefore, after considering all relevant facts and circumstances, ABC concludes that, for EPS purposes, the overall effect of the two transactions on October 1, Year 1 is a share repurchase at fair value.

Accordingly, when determining basic EPS for Year 1, ABC does not retrospectively adjust the denominator for the reverse stock split in October.

Instead, ABC treats the two transactions as an in-substance share repurchase and includes the related decrease in the number of common shares in the denominator prospectively from October 1.

Basic EPS

1 Determine the numerator

The numerator is $15,000,000.

2 Determine the denominator

With no retrospective adjustment necessary, the denominator is calculated in the usual way.

	Number of shares	Time weighting	Weighted average
Jan. 1 to Sept. 30	1,000,000	9/12	750,000
October 1 – repurchase of shares for cash	(400,000)		
Oct. 1 to Dec. 31	600,000	3/12	150,000
		12/12	
Weighted average for the year			**900,000**

3 Determine basic EPS

Basic EPS = $15,000,000 ÷ 900,000 = $16.67.

Had there not been a special dividend to shareholders, or had the reverse stock split been treated separately from the special dividend when determining the EPS amounts, ABC would have retrospectively adjusted the denominator as if the reverse stock split had been carried out at the beginning of the earliest period presented in its financial statements.

7.3.40 Disclosure of retrospective EPS effect

A retrospective adjustment to EPS to reflect a stock dividend, stock split or reverse stock split should be disclosed in the financial statements (see chapter 9). [260-10-55-12]

7.4 Rights issue

Excerpt from ASC 260-10

• • > Rights Issues

55-13 A **rights issue** whose exercise price at issuance is less than the fair value of the stock contains a bonus element that is somewhat similar to a stock dividend. If a rights issue contains a bonus element and the rights issue is offered to all existing stockholders, basic and diluted EPS shall be adjusted retroactively for the bonus element for all periods presented. If the ability to exercise the rights issue is contingent on some event other than the passage of time, the provisions of this paragraph shall not be applicable until that contingency is resolved.

55-14 The number of common shares used in computing basic and diluted EPS for all periods prior to the rights issue shall be the number of common shares outstanding immediately prior to the issue multiplied by the following factor: (fair value per share immediately prior to the exercise of the rights)/(theoretical ex-rights fair value per share). Theoretical ex-rights fair value per share shall be computed by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds expected from the exercise of the rights and dividing by the number of shares outstanding after the exercise of the rights. Example 5 (see paragraph 260-10-55-60) illustrates that provision. If the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this computation shall be established at the close of the last day on which the shares are traded together with the rights.

7.4.10 Overview

A rights issue (also known as a rights offering) enables shareholders to purchase additional common shares. They are generally granted pro rata to all common shareholders and, as an incentive, typically give the holders the opportunity to purchase shares at a discount to their fair value. Often, existing shareholders are allowed to sell their rights to other shareholders or other parties. If the rights can be sold, in our experience they are usually traded in a public market separately from the common shares before the exercise date. [260-10 Glossary]

In a rights issue in which the exercise price is less than the fair value of the common shares, the inherent discount (known as a bonus element) is similar to a stock dividend. Specifically, a rights issue is economically equivalent to a stock dividend combined with an issue at fair value. If there is a bonus element in a rights issue, Topic 260 requires retrospective adjustment to the denominators for basic and diluted EPS amounts for all periods before the rights issue, provided that the rights issue is offered to all existing shareholders. However, unlike a stock dividend, the bonus element inherent in a rights issue is measured by a prescribed formula in Topic 260 (see section 7.4.30). [260-10-55-13 – 55-14]

If the exercise of the rights is contingent on a specific event (other than the passage of time), retrospective adjustment is not made until the contingency is resolved. [260-10-55-13]

Question 7.4.10

Is an offer that is made to only some of the shareholders a rights issue?

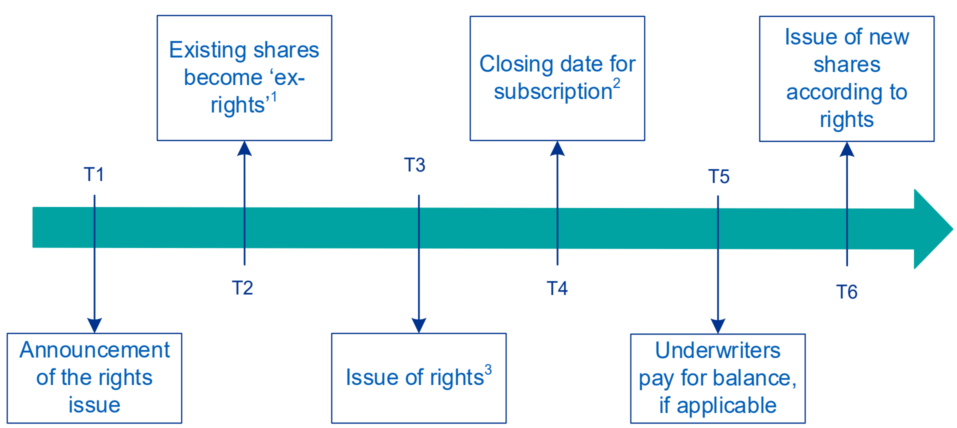
Interpretive response: No. An offer that is not made to all shareholders but is instead a negotiated transaction with a counterparty that includes a discount is not considered a rights issue. [260-10-55-13]

7.4.20 Bonus element in a rights issue

The determination of whether a bonus element exists in a rights issue is made only at the time the rights are issued. At that time, if the exercise price is equal to or greater than the market price of the shares, there is no bonus element. [260-10-55-13]

For example, assume the $10 exercise price of a right is equal to the market price of the shares on the issuance date of the rights, leading the entity to conclude that there is no bonus element. Therefore, there is no retrospective adjustment to EPS. Instead, during periods when the market price exceeds the rights' exercise price, the rights are included in the determination of diluted EPS. In the basic EPS calculation, the issuance of the common shares on exercise of the warrants affects only the weighted-average number of common shares outstanding during the period, without any further adjustment.

A rights issue typically involves the following key dates.



Notes:

1. After this date, shares are traded without the rights attached – i.e. the rights belong to the holders of existing shares on this date.
2. The date by which holders of rights have to exercise their rights and the date on which any consideration for new shares issuable under the rights is receivable.

3. There is no impact to basic or diluted EPS until the issuance of rights. Once there is a rights issuance, then there is a retrospective adjustment to the denominators for basic and diluted EPS amounts for all periods before the rights issue.

The rights issues of warrants that have a bonus element affect the calculation of both basic and diluted EPS, as illustrated in Example 7.4.10.

Example 7.4.10
Bonus element in a rights issue

ABC Corp. has a rights issue whereby every 10 common shares outstanding entitles the holder to one right (one warrant). Each right entitles the holder to one new common share at an exercise price of $2.50. The market price of ABC's shares when the rights are issued is $6.

Because the rights are issued to all of ABC's existing shareholders, and the rights contain a bonus element (market price at issuance exceeds the exercise price) the guidance on rights issues in Topic 260 applies.

Bonus element

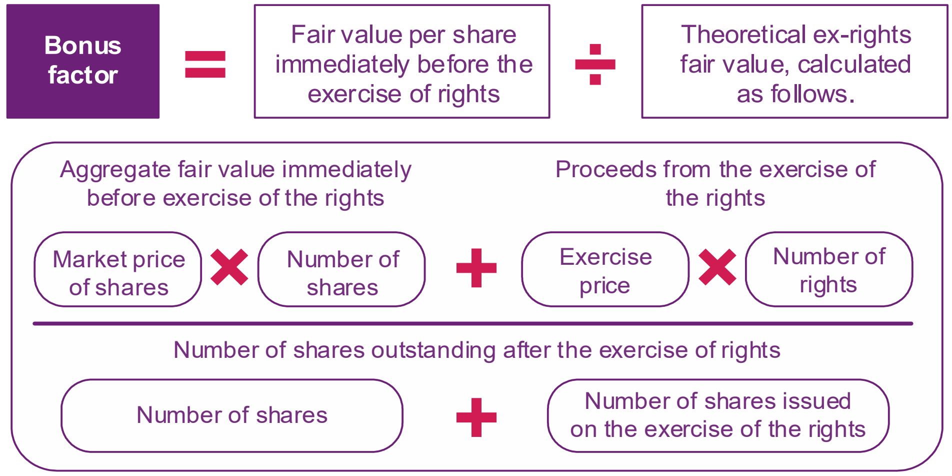
The bonus element is applied retrospectively – i.e. it requires an adjustment of the previous period's basic and diluted EPS.

The adjustment to basic EPS is made by adjusting the cumulative weighted-average number of shares outstanding at the time of the rights issue.

An adjustment may also be made to diluted EPS, but only if there are potential common shares outstanding (for example, options) at the date on which the shares with a bonus element are issued.

7.4.30 Formula for calculating the bonus element

If a rights issue is offered to all existing shareholders, the number of common shares used in calculating basic and diluted EPS for all periods before the rights issue is the number of common shares outstanding before the issue multiplied by the following factor: [260-10-55-14]



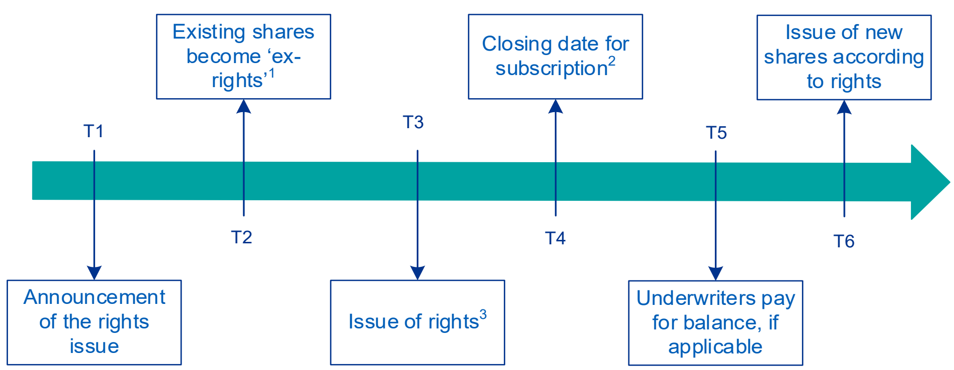
Example 7.4.20 illustrates this calculation.

Question 7.4.20

What date should be used to calculate the bonus element in a rights issue?

Interpretive response: Generally, there is a time lapse between the announcement of a rights issue and the exercise of the rights. Therefore, it may not be clear on which date the fair value of common shares should be regarded as the 'fair value per share immediately before the exercise of rights' in the formula.

As noted in section 7.4.20, rights issue typically involves the following key dates.



Notes:

1. After this date, shares are traded without the rights attached – i.e. the rights belong to the holders of existing shares on this date.
2. The date by which holders of rights have to exercise their rights and the date on which any consideration for new shares issuable under the rights is receivable.
3. There is no impact to basic or diluted EPS until the issuance of rights. Once there is a rights issuance, then there is a retrospective adjustment to the denominators for basic and diluted EPS amounts for all periods before the rights issue.

In our experience, there is typically a period rather than a single date on which the rights can be exercised (from T3 to T4 in the timeline). However, in our experience, neither the existence of this period nor the fact that the rights are to be traded separately would have an effect on determining the date on which the fair value of common shares should be regarded as the 'fair value per share immediately before the exercise of rights'.

For rights that are to be publicly traded separately from the shares before the exercise date, it is clear that Topic 260 requires use of the closing price of the shares on the last day on which the shares are traded together with the rights – i.e. the closing price on T2. [260-10-55-14]

Question 7.4.30

For rights that are not publicly traded, what does 'fair value immediately before the exercise of rights' mean?

Interpretive response: We believe that to the extent that the effect is significant, the 'fair value per share immediately before the exercise of rights' to be used should be the market price of the common shares immediately before the right goes 'ex-rights' – i.e. the closing 'cum-rights' price on T2 (see the timeline in Question 7.4.20). This is irrespective of whether the rights are to be traded separately from the shares before the exercise date.

We believe this price is most consistent with the assumptions underlying the calculation of the 'theoretical ex-rights fair value' and therefore best reflects the bonus element when used to determine the adjustment factor for a rights issue. To use the price of common shares on any later date would incorporate price movements caused by factors other than the split of the rights in the determination of the bonus element.

Example 7.4.20

Calculating the bonus element in a rights issue

On February 1, Year 2, ABC Corp. offers all of its common shareholders the right to subscribe to one new common share for every three common shares that they hold.

The following additional facts are relevant.

- Number of outstanding common shares before the rights issue: 3,000.
- Last date on which the shares are traded 'cum-rights': February 15 of Year 2.
- Market price (closing rate) of common shares on February 15, Year 2: $11.
- Last date to exercise rights: March 1, Year 2. All rights are exercised on this date.
- Exercise price for the rights: $7.

— The basic EPS in Year 1 and Year 2 without taking this transaction into consideration is $2.20, calculated as earnings for that year of $6,600 divided by the average number of shares outstanding for those years of 3,000.

Calculation – bonus factor

Because the rights issue entitles the common shareholders to subscribe to one new common share for $7, which is lower than the fair value of the shares of $11, the rights issue contains a bonus element. Therefore, ABC's basic EPS amounts are retrospectively adjusted for this bonus element.

The number of common shares outstanding for purposes of the EPS calculation before the rights issue is increased by the factor of 1.1, which is calculated as follows.

Bonus factor = 1.1 = Fair value per share immediately before the exercise of rights = 11 ÷ Theoretical ex-rights fair value, calculated as follows = 10

Aggregate fair value immediately before exercise of the rights: 11 × 3,000 shares + Proceeds from the exercise of the rights: 7 × 1,000 rights

divided by

Number of shares outstanding after the exercise of rights: 3,000 shares + 1,000 shares for rights

Basic EPS calculation – Year 1 and Year 2

Once the bonus factor is calculated, basic EPS for Year 1 and Year 2 can be retrospectively adjusted as follows.

Year 1

Basic EPS – Retrospective adjustment

1 Determine the numerator

The numerator remains unchanged at $6,600.

2 Determine the denominator

With retrospective adjustment, the denominator reflects the average number of shares outstanding of 3,000 increased by the factor 1.1 – i.e. 3,300 shares.

3 Determine basic EPS

Basic EPS = $6,600 ÷ 3,300 = $2.00

Year 2

Basic EPS – Retrospective adjustment

1 Determine the numerator

The numerator remains unchanged at $6,600.

2 Determine the denominator

With retrospective adjustment, the denominator reflects the average number of shares outstanding of 3,000, which (as in Year 1) is increased by the factor 1.1. For Year 2, the factor is applied until the date on which the rights are exercised.

	Number of shares	Time weighting	Weighted average
Outstanding common shares	3,000		
Bonus factor	1.1		
January to February	3,300	2/12	550
March 1– plus issuance of rights shares less effect of bonus factor [1,000 – (3,300 – 3,000)]	4,000	10/12	3,333
		12/12	
Weighted average for the period			**3,883**

3 Determine basic EPS

Basic EPS = $6,600 ÷ 3,883 = $1.70.

Example 5 in Topic 260 (reproduced below) illustrates the accounting for a rights issue.

Excerpt from ASC 260-10

• > Example 5: Rights Issues

55-60 This Example illustrates the provisions for stock rights issues that contain a bonus element as described in paragraphs 260-10-55-13 through 55-14. This Example has the following assumptions:

a. Net income was $1,100 for the year ended December 31, 20X0.
b. 500 common shares were outstanding for the entire year ended December 31, 20X0.

c. A rights issue was offered to all existing shareholders in January 20X1. The last date to exercise the rights was March 1, 20X1. The offer provided 1 common share for each 5 outstanding common shares (100 new shares).
d. The exercise price for the rights issue was $5 per share acquired.
e. The fair value of 1 common share was $11 at March 1, 20X1.
f. Basic EPS for the year 20X0 (prior to the rights issuance) was $2.20.

55-61 As a result of the bonus element in the January 20X1 rights issue, basic and diluted EPS for 20X0 will have to be adjusted retroactively. The number of common shares used in computing basic and diluted EPS is the number of shares outstanding immediately prior to the rights issue (500) multiplied by an adjustment factor. Prior to computing the adjustment factor, the theoretical ex-rights fair value per share must be computed. Those computations follow.

Theoretical ex-rights fair value per share[(a)]	$10	$= \dfrac{(500 \times \$11) + (100 \times \$5)}{(500 + 100)}$
Adjustment factor[(b)]	1.1	$11 ÷ $10
Denominator for restating basic EPS	550	500 × 1.1
Restated basic EPS for 20X0	$2.00	$1,100 ÷ 550

(a) The equation for computing the theoretical ex-rights fair value per share is:

$$\frac{\text{Aggregate fair value of shares prior to exercise of rights + Proceeds from exercise of rights}}{\text{Total shares outstanding after exercise of rights}}$$

(b) The equation for computing the adjustment factor is:

$$\frac{\text{Fair value per share immediately prior to exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

Diluted EPS would be adjusted retroactively by adding 50 shares to the denominator that was used in computing diluted EPS prior to the restatement.

7.5 Reverse acquisitions and common control business combinations

Excerpt from ASC 260-10

• > Business Combinations and Reorganizations

55-17 When common shares are issued to acquire a business in a business combination, the computations of EPS shall recognize the existence of the new shares only from the acquisition date. In reorganizations, EPS computations shall be based on analysis of the particular transaction and the provisions of this Subtopic.

7.5.10 Overview

Retrospective adjustments to EPS are required for reverse acquisitions and reorganizations, also referred to as business combinations between entities under common control (see Question 7.5.10). In contrast, business combinations involving unrelated parties are accounted for prospectively, with no retrospective adjustment to EPS. Restructurings, which are common in an IPO, are analyzed on a transaction-by-transaction basis to determine how they should be included in EPS. [805-40-45-3, 260-10-55-17]

Question 7.5.10

When effecting a business combination between entities under common control, is EPS retrospectively adjusted?

Interpretive response: Yes. Although Topic 805 eliminated the pooling-of-interest method for business combinations, it retained *as-if* pooling for common control transactions. In an as-if pooling for transactions among entities under common control, the entities' financial positions, results of operations, and cash flows are added together and reported as if the component entities had always been combined (starting with the earliest period that the entities are under common control). We believe an entity generally should apply this same concept to EPS calculations, except for certain dropdown transactions in MLP structures (see section 9.3).

If cash is paid in the transaction, there is no EPS effect. If an entity issues shares, rather than cash, to shareholders of the contributing entity, the issuing entity retrospectively adjusts prior-period EPS to reflect the restated income or loss that would have been reported in prior periods as if the entities under common control had always been combined. Generally, the numerator is equal to the sum of the numerators of the combined entities and the denominator reflects aggregate adjusted weighted-average outstanding shares, based on equivalent shares of the combined entity, as reflected in this diagram.

$$\left(\frac{\text{Number of shares issued by acquirer}}{\text{Weighted-average number of shares of acquiree}} \times \text{Weighted-average number of shares and potential shares of acquiree}\right) + \text{Weighted-average number of shares and potential shares of acquirer} = \text{Denominator}$$

However, if either of the combined entities has potential common shares, the guidance in paragraph 260-10-55-16 regarding prior-period adjustments applies (see section 7.6). The surviving entity determines if the retrospective adjustment of income from continuing operations causes potential common shares originally considered to be dilutive to become antidilutive (or vice versa) (see section 7.5.20).

See section 9.3 for guidance on an MLP's presentation of historical earnings per unit (EPU) after a dropdown transaction accounted for as a transaction between entities under common control.

Example 7.5.10
Transactions among entities under common control

ABC Corp. and DEF Corp. are under common control. On March 15, Year 2, ABC issues 3.5 million shares to acquire all 7 million outstanding shares of DEF. ABC and DEF only have common shares outstanding (i.e. no potential common shares) and no new common shares has been issued or repurchased since inception.

Basic EPS calculations – Year 1

As of December 31, Year 1, ABC and DEF calculate basic EPS as follows.

Basic EPS			
Step		**ABC**	**DEF**
1 Numerator	Income available to common shareholders:	$100 million	$20 million
2 Denominator	Weighted-average common shares outstanding:	14 million	7 million
3 Basic EPS		$7.14 [$100 million ÷14 million]	$2.86 [$20 million ÷7 million]

Because ABC and DEF are under common control and ABC acquired DEF on March 15, Year 2, EPS for prior periods is restated. The numerator is equal to the sum of the numerators of the combined entities ($120 million) and the denominator reflects the aggregate adjusted weighted-average outstanding shares, to equal 17.5 million, (calculated as follows):

$$\left(\frac{\begin{array}{c}\text{Number of shares issued by ABC}\\ \text{3.5 million shares}\end{array}}{\begin{array}{c}\text{Weighted-average number of shares of DEF}\\ \text{7 million shares}\end{array}} \times \begin{array}{c}\text{Weighted-average number of shares}\\ \text{and potential shares of DEF}\\ \text{7 million shares}\end{array}\right) + \begin{array}{c}\text{Weighted-average number of shares}\\ \text{and potential shares of ABC}\\ \text{14 million shares}\end{array} = \begin{array}{c}\text{Denominator}\\ \text{17.5 million shares}\end{array}$$

Therefore, restated EPS as of December 31, Year 1 equals $6.86 ($120 million ÷ 17.5 million shares) for the combined entity.

If the shareholders of the contributing entity receive only cash (i.e. no shares), there is no effect on the denominator.

See section 9.3 for guidance on a MLP's presentation of historical EPU after a dropdown transaction accounted for as a transaction between entities under common control.

7.5.20 Reverse acquisitions

Excerpt from ASC 805-40

> Required EPS Presentation on the Face of the Income Statement

45-4 In calculating the weighted-average number of common shares outstanding (the denominator of the earnings-per-share [EPS] calculation) during the period in which the reverse acquisition occurs:

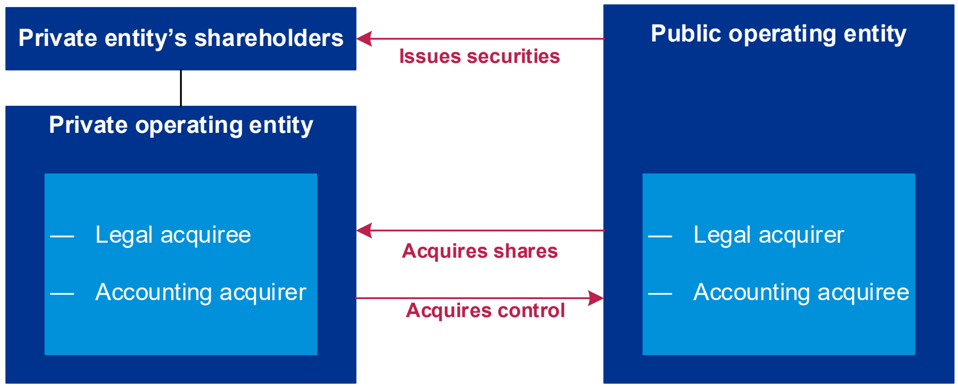
a. The number of common shares outstanding from the beginning of that period to the **acquisition date** shall be computed on the basis of the weighted-average number of common shares of the legal acquiree (accounting acquirer) outstanding during the period multiplied by the exchange ratio established in the merger agreement.
b. The number of common shares outstanding from the acquisition date to the end of that period shall be the actual number of common shares of the legal acquirer (the accounting acquiree) outstanding during that period.

45-5 The basic EPS for each comparative period before the acquisition date presented in the consolidated financial statements following a reverse acquisition shall be calculated by dividing (a) by (b):

a. The income of the legal acquiree attributable to common shareholders in each of those periods
b. The legal acquiree's historical weighted-average number of common shares outstanding multiplied by the exchange ratio established in the acquisition agreement.

A reverse acquisition is a business combination in which the legal acquirer (i.e. the entity that issues the securities) is identified as the acquiree for accounting purposes, and the legal acquiree is the acquirer for accounting purposes.

For example, a private operating entity wants to become a public entity but does not want to register its common shares; instead, it wishes to 'go public' through the reverse acquisition. To accomplish that, the private entity arranges for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In form, the public entity is the legal acquirer because it issues its equity interests, and the private entity is the legal acquiree because its equity interests are acquired. However, if in substance the private entity (as legal acquiree) obtains control over the public entity (as legal acquirer) under Subtopic 805-40, the public entity is the accounting acquiree and the private entity the accounting acquirer.



Further guidance on reverse acquisitions can be found in Subtopic 805-40 and chapter 9 of KPMG Handbook, Business combinations. Among other things, reverse acquisitions are accounted for using the acquisition method.

EPS implications

Of particular relevance to the EPS calculation is the presentation of the legal acquirer's consolidated financial statements following a reverse acquisition.

The equity structure in those consolidated financial statements reflects the equity structure of the legal acquirer, including the equity interests issued by the legal acquirer to effect the reverse acquisition. However, apart from the equity structure, those consolidated financial statements represent the continuation of the financial statements of the legal acquiree. Accordingly, there are two specific challenges for determining EPS.

— The representation of comparative consolidated financial information as a continuation of that of the legal acquiree after a reverse acquisition necessitates another form of retrospective adjustment when determining EPS amounts for the current period and restating those for the comparative periods.

— There is a 'mismatch' between the earnings (which is a continuation of the legal acquiree) and the equity structure (which reflects that of the legal acquirer).

Subtopic 805-40 includes specific requirements on these retrospective adjustments to resolve the above mismatch and to better reflect the substance of the reverse acquisition and address the calculation of EPS in such situations.

The basic EPS amounts for each period presented in the consolidated financial statements following a reverse acquisition are calculated as follows. [805-40-45-4 – 45-5]

Basic EPS after a reverse acquisition: Current period		
	From beginning of period to date of acquisition	**From date of acquisition to reporting date**
Numerator	Consolidated income of the combined entity (with legal acquirer/accounting acquiree's earnings included from the acquisition date to the end of the period) available to common shareholders for the period	

Basic EPS after a reverse acquisition: Current period			
Denominator	Weighted-average number of common shares of the legal acquiree outstanding pre-acquisition × Exchange ratio established in the acquisition agreement	+	Weighted-average number of common shares of the legal acquirer outstanding post-acquisition

Basic EPS after a reverse acquisition: Comparative periods	
Numerator	Income of the legal acquiree available to common shareholders for the period
Denominator	Weighted-average number of common shares of the legal acquiree outstanding pre-acquisition × Exchange ratio established in the acquisition agreement

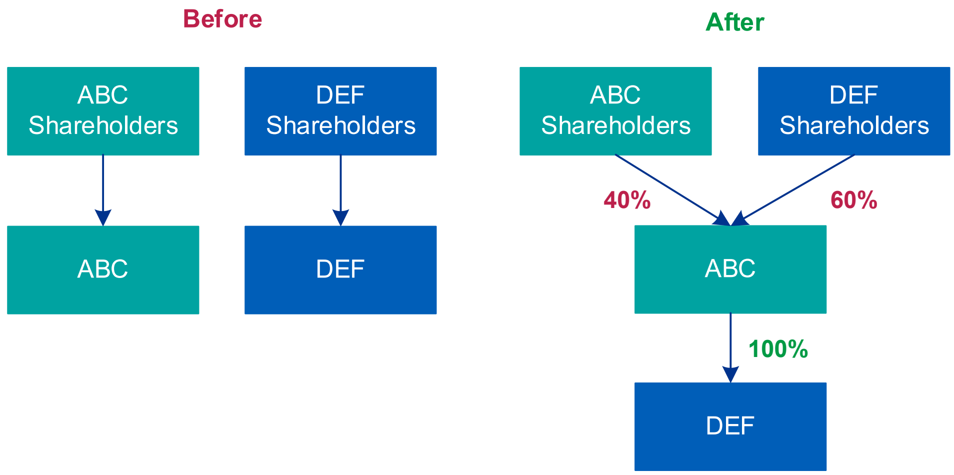
If there is no change in the number of outstanding common shares of the legal acquiree during the pre-acquisition period, the exchange ratio equals the number of common shares issued by the legal acquirer in the reverse acquisition.

Example 7.5.20
Reverse acquisition – basic EPS

On September 30, Year 2, ABC Corp. issues common shares to acquire 100% of DEF Corp. The transaction is determined to be a reverse acquisition in which DEF is identified as the accounting acquirer.

The following additional information is relevant.

- Immediately before the business combination, DEF and ABC have 60 and 100 common shares outstanding respectively.
- ABC issues 150 common shares to the shareholders of DEF as consideration for their 60 shares in DEF – i.e. 2.5 shares in ABC for each share in DEF.
- At the date of acquisition, the market prices of one share in DEF and ABC are $45 and $18 respectively. There is no control premium.
- The former shareholders of DEF and ABC own 60% (150 ÷ 250) and 40% (100 ÷ 250), respectively, of the combined entity.



— DEF's net income for Year 1 is $600. DEF's consolidated net income for Year 2 (which includes ABC's net income from the date of acquisition) is $800.

There are no changes in the number of DEF's common shares outstanding during Year 1 and Year 2. The number of shares is as follows.

Date		Number of shares in ABC	Number of shares in DEF
January 1, Year 1		100	60
December 31, Year 1		100	60
September 30, Year 2	Acquisition – issue of shares	+150	–
December 31, Year 2		250	60

Basic EPS calculations for Year 1 and Year 2 in DEF's consolidated financial statements

Year 1

Basic EPS – Retrospective adjustment

1 Determine the numerator

The numerator is $600.

2 Determine the denominator

For Year 1, the comparative period, this is calculated as the weighted-average number of common shares of the legal acquiree (DEF) outstanding during the period multiplied by the exchange ratio established in the acquisition agreement.

This equals a weighted-average number of shares of DEF outstanding (60) multiplied by the number of shares in ABC exchanged for each share in DEF (2.5) – i.e. 150.

3 Determine basic EPS

Basic EPS = \$600 ÷ 150 = \$4.00.

Year 2

Basic EPS

1 Determine the numerator

The numerator is \$800.

2 Determine the denominator

For Year 2, the period in which the acquisition occurs, the denominator is calculated based on the formula set out in section 7.3.30:

— the weighted-average number of shares of ABC outstanding from January 1, Year 2 to September 30, Year 2 (60) multiplied by the number of shares in ABC exchanged for each share in DEF (2.5) – i.e. the number of common shares issued by ABC in the reverse acquisition; plus

— the number of shares in ABC outstanding from September 30, Year 2 to December 31, Year 2 – i.e. 250.

	Number of shares	Time weighting	Weighted average
Common shares of ABC	60		
Exchange ratio	2.5		
Deemed outstanding January to September (DEF)	150	9/12	113
September 30 – date of acquisition	100		
September to December (ABC)	250	3/12	63
		12/12	
Weighted average for the period (adjusted for rounding)			**175**

3 Determine basic EPS

Basic EPS = \$800 ÷ 175 = \$4.57.

Question 7.5.20

Is EPS retrospectively adjusted if financial statements are reissued for a period prior to a reverse acquisition?

Background: ABC Corp. enters into a reverse acquisition with DEF Corp. and DEF is the accounting acquirer. On July 15, Year 1, DEF also enters into a 1:3 reverse stock split to reduce the number of shares outstanding to facilitate the share exchange. The reverse acquisition closes on July 18, Year 1 and ABC files a related Form 8-K. DEF's financial statements for the previous quarter (June 30, Year 1) are included in ABC's Form 8-K/A that is subsequently required to be filed.

Interpretive response: No. An entity does not retrospectively adjust its EPS calculations in financial statements for periods before a reverse acquisition. However, once financial statements are issued for a period that includes, or that is after, the reverse acquisition, an entity then retrospectively adjusts comparative information that is presented together with post-acquisition financial information. In this example, this is done in the quarter following the reverse acquisition (September 30, Year 1). [805-40-45-4 – 45-5]

7.6 Prior-period adjustments

Excerpt from ASC 260-10

• • > Prior-Period Adjustments

55-15 If authoritative literature requires that a restatement of the results of operations of a prior period be included in the income statement or summary of earnings, then EPS data given for the prior period or periods shall be restated. The effect of the restatement, expressed in per-share terms, shall be disclosed in the period of restatement.

55-16 Restated EPS data shall be computed as if the restated income or loss had been reported originally in the prior period or periods. Thus, it is possible that common stock assumed to be issued upon exercise, conversion, or issuance of potential common shares in accordance with the provisions of this Subtopic may not be included in the computation of restated EPS amounts. That is, retroactive restatement of income from continuing operations could cause potential common shares originally determined to be dilutive to become antidilutive pursuant to the control number provision in paragraph 260-10-45-18. The reverse also is true. Retroactive restatement also may cause the numerator of the EPS computation to change by an amount that differs from the amount of the retroactive adjustment.

55-16A See paragraph 260-10-55-111 for guidance on the presentation of prior-period earnings per unit for entities within the scope of the Master Limited Partnerships Subsections that retrospectively adjust their financial statements and financial information for prior periods as a result of a **dropdown**

transaction accounted for under the Transactions Between Entities Under Common Control Subsections of Subtopic 805-50.

7.6.10 Overview

Comparative information in financial statements may be restated when an entity makes a retrospective correction of items due to prior-period errors or when an entity applies a new accounting policy retrospectively. Retrospective adjustment of EPS is also required if the prior-period adjustment has an income statement effect. [260-10-55-15]

Retrospective restatements for errors or accounting policy adjustments often have an effect on the income presented for the periods – and therefore on the numerator of EPS. Therefore, unlike in the other sections of this chapter, in which retrospective adjustments generally involve an adjustment to the denominator for EPS, the retrospective adjustments in this section involve only changes to the numerator.

Additionally, also unlike the retrospective adjustments in this chapter's other sections, when there is a retrospective restatement of items or a retrospective application of an accounting policy, it is generally necessary to reconsider the previous EPS calculations from scratch, rather than being able to take any shortcuts. For example, a retrospective change in income may result in previously antidilutive potential common shares becoming dilutive when redetermining diluted EPS or vice versa. [260-10-55-16]

7.6.20 Changes in EPS amounts

To illustrate the need to reconsider EPS from scratch as a result of prior-period errors or adoption of a new accounting policy retrospectively, Example 4.7.10 is extended as follows.

Example 7.6.10
Need to reconsider the EPS calculation from scratch

Below are the results of ABC Corp. for the year ended December 31, Year 2, both as previously reported and as restated following a change in its accounting policies.

	Year 2 (As originally reported)	Year 2 (As restated)
Income (loss) from continuing operations	$ 1,000,000	$(1,000,000)
Income (loss) from discontinued operations	(3,000,000)	(3,000,000)
Net income (loss)	**$(2,000,000)**	**$(4,000,000)**

- The adoption of a new accounting policy in Year 3 results in the earnings for Year 2 being retrospectively adjusted, with income from continuing operations reduced by $2,000,000.
- In Year 2, the average number of common shares outstanding for ABC is 200,000.
- ABC has only one type of potential common shares, 20,000 contingently issuable shares. These shares are issuable to the former shareholders of Subsidiary at the end of Year 3 if the market price of the shares in Subsidiary is above $150 at September 30, Year 3.
- At December 31, Year 2, the market price of the shares in Subsidiary is above $150.

EPS calculations – Year 2

The treatment of contingently issuable shares is discussed in section 6.10. The calculation of diluted EPS takes into account the number of common shares that would be issued if the market price at the reporting date were the market price at the end of the contingency period – i.e. 20,000 potential common shares in this example.

Therefore, in Year 2 these 20,000 potential common shares were originally included in the diluted EPS calculation because they were dilutive. However, they are no longer included in the retrospective diluted EPS calculation for Year 2 because they become antidilutive from the perspective of the restated financial statements due to the adjusted level of profits from continuing operations (i.e. a loss). This can best be explained by comparing the results of all of the EPS calculations in the example.

Basic EPS						
Step	Year 2 – original			Year 2 – restated		
	Continuing operations	Discontinued operations	Total operations	Continuing operations	Discontinued operations	Total operations
1 Numerator	$1,000,000	($3,000,000)	($2,000,000)	($1,000,000)	($3,000,000)	($4,000,000)
2 Denominator	200,000	200,000	200,000	200,000	200,000	200,000
3 Basic EPS	$5.00	($15.00)	($10.00)	($5.00)	($15.00)	($20.00)

Diluted EPS						
Step	Year 2 – original			Year 2 – restated		
	Continuing operations	Discontinued operations	Total operations	Continuing operations	Discontinued operations	Total operations
1 Potential common shares	Contingently issuable common shares	Contingently issuable common shares	Contingently issuable common shares	Contingently issuable common shares	Contingently issuable common shares	Contingently issuable common shares

Diluted EPS						
Step	Year 2 – original			Year 2 – restated		
2 EPIS (adjustment of denominator)	20,000	20,000	20,000	Antidilutive: N/A	Antidilutive: N/A	Antidilutive: N/A
3 Rank	Only 1 class	Only 1 class	Only 1 class	N/A	N/A	N/A
4 Basic EPS	See above	See above	See above	See above	See above	See above
5 Diluted EPS	$4.55	($13.64)	($9.09)	($5.00)	($15.00)	($20.00)

Originally, in Year 2, the inclusion of the 20,000 potential common shares increased the number of outstanding common shares to 220,000. This resulted in a diluted EPS amount for continuing operations (i.e. the control number) that was lower than the basic EPS for continuing operations: $4.55 [$1,000,000 ÷ 220,000] is lower than $5.00 [$1,000,000 ÷ 200,000]. Therefore, in Year 2 the increased number of shares of 220,000 was used for each of the diluted EPS calculations.

However, in the restated amounts for Year 2, the inclusion of the 20,000 potential common shares to increase the number of outstanding common shares to 220,000 results in a diluted loss per share amount for continuing operations that is lower than the basic loss per share for continuing operations: $4.55 [$1,000,000 ÷ 220,000] is a lower loss than $5 [$1,000,000 ÷ 200,000]. Therefore, because this is a decrease in the loss (and not income) per share from continuing operations, the potential common shares are antidilutive and therefore are not brought into the diluted EPS calculation. So in the restatements for Year 2, just the number of common shares of 200,000 is used for each of the diluted EPS calculations.

As a result, the restated diluted EPS for Year 2 is different from the amounts that were originally presented. Further, EPS is affected by more than just the change in the adjustment to earnings that arose from applying the new accounting policy. The new accounting policy affects the numerator and applying the provisions of Topic 260 results in a change to the denominator as well.

Observation
EPS restatement for prior period adjustments only

When EPS is restated for prior period adjustments, it includes only the effect of the prior period adjustment. An entity may not reflect nonrecognized subsequent events when restating prior EPS amounts for a prior period adjustment. However, in some cases pro forma EPS disclosure may be required (see section 9.2.30).

7.6.30 Disclosure of EPS effect of prior-period adjustment

An entity should disclose the effect of a retrospective restatement resulting from a prior-period adjustment. Disclosures are discussed in chapter 9. [260-10-55-15]

8. EPS in interim financial statements

Detailed contents

Item significantly updated in this edition: #

8.1 How the standard works

This chapter discusses the requirements on the presentation of EPS in interim financial statements, covering:

- entities that issue interim financial statements or financial information (see section 8.2); and
- the quarterly and year-to-date approach to calculating EPS amounts for an interim period (see section 8.3).

For the presentation and disclosure requirements that apply to interim periods, see section 9.2.20.

If an entity is in the scope of Topic 260, it presents basic and diluted EPS in its interim financial statements.

The following guidelines apply to calculating EPS in quarterly and year-to-date periods.

Each quarterly calculation is determined independently. [260-10-55-3]

Year-to-date calculation of diluted EPS is based on the weighted-average of incremental shares included in each interim period in the year-to-date calculation, except that:

- if there is a year-to-date loss, potential common shares are not included because they would be antidilutive; and
- if there is year-to-date income but there was a loss in one or more interim periods included in the year-to-date period, potential common shares that were excluded in that interim period because they were antidilutive are included in the year-to-date calculation (if they are dilutive). [260-10-55-3 – 55-3B]

Contingent shares are included on a weighted-average basis for year-to-date calculations – i.e. as year-to-date is on a weighted-average basis, they are weighted for interim periods in which they are included. However, for interim periods they are included as of the beginning of that period. [260-10-45-49, 55-54]

8.2 Entities required to present EPS in interim financial statements

An entity presents basic and diluted EPS in the interim financial statements if it is in the scope of Topic 260 (see section 2.1).

Question 8.2.10

Should an entity present EPS information in interim financial statements if its common shares are not yet traded at the interim reporting date?

Interpretive response: Neither Topic 260 nor Topic 270 is clear about the requirements to present EPS information when an entity's common shares are not yet traded at the interim reporting date (i.e. no shares are outstanding at that time) but are publicly traded by the time its interim financial statements for that period are issued (available to be issued).

As noted in Question 2.2.20, in such circumstances the entity is generally in the process of filing its financial statements with a securities commission or other regulatory organization for this purpose at the interim reporting date. Therefore, we believe the entity should present EPS information in these interim financial statements.

Question 8.2.20

Should an entity present EPS information in interim financial statements if its common shares or potential common shares were listed for only a portion of the interim period?

Interpretive response: As noted in section 2.2.10, we believe in this situation the entity should present EPS information in the interim financial statements for all periods for which an income statement is presented – not just for the periods in which the entity's common shares or potential common shares are publicly traded.

8.3 EPS calculations

8.3.10 Overview

Excerpt from ASC 270-10

05-1 The Interim Reporting Topic clarifies the application of accounting principles and reporting practices to interim financial information, including interim financial statements and summarized interim financial data of **publicly traded companies** issued for external reporting purposes. Interim financial information may include current data during a fiscal year on financial position, results of operations, comprehensive income, and cash flows. This information may be issued on a monthly or quarterly basis or at other intervals and may take the form of either complete financial statements or summarized financial data. Interim financial information often is provided for each interim period or on a cumulative year-to-date basis, or both, and for the corresponding periods of the preceding year.

> Accounting Principles and Practices

45-1 Interim financial information is essential to provide investors and others with timely information as to the progress of the entity. The usefulness of such information rests on the relationship that it has to the annual results of operations. Accordingly, each interim period should be viewed primarily as an integral part of an annual period.

45-2 In general, the results for each interim period shall be based on the accounting principles and practices used by an entity in the preparation of its latest annual financial statements unless a change in an accounting practice or policy has been adopted in the current year (see paragraphs 270-10-45-12 through 45-16). However, certain accounting principles and practices followed for annual reporting purposes may require modification at interim reporting dates so that the reported results for the interim period may better relate to the results of operations for the annual period. Paragraphs 270-10-45-4 through 45-11 sets forth the modifications that are necessary or desirable at interim dates in accounting principles or practices followed for annual periods.

Topic 270 contains a general principle that the interim financial information is useful because it provides timely information in relation to annual results. Therefore, interim financial information is usually presented for both interim and year-to-date periods. Also, the interim information is generally based on the same accounting principles and policies used in preparing the annual financial statements. [270-10-45-1– 45-2]

Question 8.3.10

For what income statement components should EPS be presented in interim financial statements?

Interpretive response: Paragraph 270-10-50-1(b) specifically states that basic and diluted EPS should be determined under Topic 260. We believe an entity should calculate interim EPS amounts for the same income statement components as in Topic 260.

Therefore, in its interim financial statements an entity should calculate EPS for income (loss) from continuing operations, discontinued operations and net income (loss).

Question 8.3.20

Are retrospective adjustments made to EPS information in condensed interim financial statements when an entity's capital structure changes?

Interpretive response: As noted in section 7.3, for the purposes of annual financial statements both basic and diluted EPS are retrospectively adjusted for a stock dividend, stock split or reverse stock split that occurs after the reporting date but before the financial statements are issued (available to be issued).

The issue of retrospective adjustments in the context of condensed interim financial statements is not explicitly addressed in Topic 260 or Topic 270. However, in line with the general principle in Topic 270 that the same accounting policies as are applied in annual financial statements should be applied in interim financial statements, similar adjustments are made in condensed interim financial statements if a stock dividend, stock split or reverse stock split occurs after the interim reporting date but before the interim financial statements are issued. [270-10-45-2]

8.3.20 Quarterly EPS calculation

Excerpt from ASC 260-10

• > Applying the Treasury Stock Method: Year-to-Date Computations

55-3 The number of incremental shares included in quarterly diluted EPS shall be computed using the average market prices during the three months included in the reporting period…

When calculating EPS in an interim period, the quarterly calculation is based on the weighted-average number of shares outstanding during the quarter. This does not affect basic EPS calculations because the calculation is based on the actual weighted-average number of shares outstanding. However, for diluted EPS calculations, which includes dilutive potential common shares, conversion, exercise or settlement of these shares is considered to take place as of the beginning of the quarter; or from the date the instrument is outstanding, if later.

Topic 260 indicates that dilutive shares are determined independently for each period presented. Therefore, an entity does not retrospectively adjust the diluted EPS of any prior period presented for changes in the assumptions used in the calculation or for the conversion of potential common shares into common shares – e.g. when a convertible instrument is dilutive in one period but not in the another. [260-10-55-3]

8.3.30 Year-to-date EPS calculation

Excerpt from ASC 260-10

• > Applying the Treasury Stock Method: Year-to-Date Computations

55-3 The number of incremental shares included in quarterly diluted EPS shall be computed using the average market prices during the three months included in the reporting period. For year-to-date diluted EPS, the number of incremental shares to be included in the denominator shall be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation. Example 1 (see paragraph 260-10-55-38) provides an illustration of that provision.

55-3A Computation of year-to-date diluted EPS when an entity has a year-to-date loss from continuing operations including one or more quarters with income from continuing operations and when in-the-money options or warrants were not included in one or more quarterly diluted EPS computations because there was a loss from continuing operations in those quarters is as follows. In computing year-to-date diluted EPS, year-to-date income (or loss) from continuing operations shall be the basis for determining whether or not dilutive potential common shares not included in one or more quarterly computations of diluted EPS shall be included in the year-to-date computation.

55-3B Therefore:

a. When there is a year-to-date loss, potential common shares should never be included in the computation of diluted EPS, because to do so would be antidilutive.
b. When there is year-to-date income, if in-the-money options or warrants were excluded from one or more quarterly diluted EPS computations because the effect was antidilutive (there was a loss from continuing operations in those periods), then those options or warrants should be included in the diluted EPS denominator (on a weighted-average basis) in the year-to-date computation as long as the effect is not antidilutive. Similarly, contingent shares that were excluded from a quarterly computation solely because there was a loss from continuing operations should be included in the year-to-date computation unless the effect is antidilutive.

Example 12 (see paragraph 260-10-55-85) illustrates this guidance.

• > Contingently Issuable Shares

45-49 For year-to-date computations, contingent shares shall be included on a weighted-average basis. That is, contingent shares shall be weighted for the interim periods in which they were included in the computation of diluted EPS.

• > Contracts That May Be Settled in Stock or Cash

55-34 Year-to-date diluted EPS calculations may require an adjustment to the numerator in certain circumstances. For example, for contracts that are share settled for EPS purposes, the numerator adjustment is equal to the earnings effect of the change in the fair value of the asset or liability recorded pursuant to Section 815-40-35 during the year-to-date period. In that example, the number of incremental shares included in the denominator should be determined in accordance with the guidance in paragraph 260-10-55-3.

Basic EPS

When calculating basic EPS, the weighted-average number of shares outstanding is calculated separately for the quarterly and for the year-to-date periods, as shown in Example 8.3.10.

Example 8.3.10
Arithmetic average of shares outstanding – basic EPS

ABC Corp. is calculating the denominator for its basic EPS calculation for the quarter ended June 30, Year 1. It had 100 common shares outstanding on the first day of the quarter and issued 20 more shares on April 15 on exercise of outstanding stock options. It repurchased 30 shares on June 10.

Quarterly EPS basic denominator calculation – Year 1

Basic EPS

2 Determine the denominator

There are 91 days in the quarter. ABC weights the number of shares outstanding during the period as follows.

	Number of shares	Time weighting	Weighted average
April 1 – April 14	100	14/91	15
April 15 – June 9	120	56/91	74
June 10 – June 30	90	21/91	21
		91/91	
Weighted-average number of shares outstanding			**110**

Year-to-date EPS basic denominator calculation – Year 1

The year-to-date calculation of the denominator of basic EPS is done in a similar manner. ABC is determining the denominator of its year-to-date EPS calculation for the six months ended June 30, Year 1. 100 common shares were outstanding for all of January, February and March.

Basic EPS

2 Determine the denominator

There are 181 days in the six-month period. ABC weights the number of shares outstanding during the period as follows.

	Number of shares	Time weighting	Weighted average
January 1 – April 14	100	104/181	58
April 15 – June 9	120	56/181	37
June 10 – June 30	90	21/181	10
		181/181	
Weighted-average number of shares outstanding			**105**

Diluted EPS

For year-to-date diluted EPS calculations, the denominator is based on the weighted-average number of shares used in each quarterly calculation unless one or more interim periods is a loss, or the year-to-date amount is a loss. This means that the year-to-date calculation is not a completely independent calculation for the entire period to date, but rather is based on the individual quarterly calculations, including those amounts that would have been included in the individual interim periods if there had been income in the individual interim periods. Therefore, assumptions of conversion, exercise or settlement of potential common shares are not considered as of the beginning of the year-to-date period. [260-10-55-3]

If shares (i.e. contingently issuable shares and potential common shares) were not included in a particular quarter's diluted EPS calculation because they were antidilutive, they are included in the weighted-average year-to-date periods if they are dilutive to the year-to-date period. This approach is similar to the method an entity uses to incorporate incremental shares in year-to-date calculations when it applies the treasury stock method (see section 4.4.40). [260-10-45-49, 55-3A – 55-3B]

Observation
Potential differences between interim and year-to-date EPS information

Topic 260 requires that each quarter's EPS calculations be determined independently. This may cause volatility in EPS between quarters, if securities are considered dilutive in one quarter and antidilutive in another.

Further, Topic 260 requires that the year-to-date calculation be based on the individual quarterly calculations; however, in some cases shares that were excluded during the quarterly calculation are included in the year-to-date calculations. This may result in a year-to-date diluted EPS amount that does not equal the sum of the individual quarter diluted EPS amounts.

A more detailed understanding of how this year-to-date approach is applied with respect to potential common shares can be derived from Examples 3 and 12 in Topic 260 (reproduced below). At the end of this section are KPMG examples of year-to-date calculations that use the five-step approach to calculating diluted EPS that was explained in section 4.1.

Excerpt from ASC 260-10

• > Example 3: Contingently Issuable Shares

55-53 This Example illustrates the contingent share provisions described in paragraphs 260-10-45-13 and 260-10-45-48 through 45-57. This Example has the following assumptions:

a. Entity A had 100,000 shares of common stock outstanding during the entire year ended December 31, 20X1. It had no options, warrants, or convertible securities outstanding during the period.
b. Terms of a **contingent stock agreement** related to a recent business combination provided the following to certain shareholders of Entity A:g
    1. 1,000 additional common shares for each new retail site opened during 20X1
    2. 5 additional common shares for each $100 of consolidated, after-tax net income in excess of $500,000 for the year ended December 31, 20X1.
c. Entity A opened two new retail sites during the year:
    1. One on May 1, 20X1
    2. One on September 1, 20X1.
d. Entity A's consolidated, year-to-date after-tax net income was:
    1. $400,000 as of March 31, 20X1
    2. $600,000 as of June 30, 20X1
    3. $450,000 as of September 30, 20X1
    4. $700,000 as of December 31, 20X1.

55-54 Note that in computing diluted EPS for an interim period, contingent shares are included as of the beginning of the period. For year-to-date computations, paragraph 260-10-45-49 requires that contingent shares be included on a weighted-average basis.

55-55 The following table illustrates the quarterly and annual calculation of basic and diluted EPS.

55-56

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Basic EPS Computation					
Numerator	$ 400,000	$ 200,000	$ (150,000)	$ 250,000	$ 700,000
Denominator:					
Common shares outstanding	100,000	100,000	100,000	100,000	100,000
Retail site contingency	0	667[(a)]	1,333[(b)]	2,000	1,000[(c)]
Earnings contingency[(d)]	0	0	0	0	0
Total shares	100,000	100,667	101,333	102,000	101,000
Basic EPS	$ 4.00	$ 1.99	$ (1.48)	$ 2.45	$ 6.93

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Diluted EPS Computation					
Numerator	$ 400,000	$ 200,000	$ (150,000)	$ 250,000	$ 700,000
Denominator:					
Common shares outstanding	100,000	100,000	100,000	100,000	100,000
Retail site contingency	0	1,000	2,000	2,000	1,250[(e)]
Earnings contingency	0[(f)]	5,000[(g)]	0[(h)]	10,000[(i)]	3,750[(j)]
Total shares	100,000	106,000	102,000	112,000	105,000
Diluted EPS	$ 4.00	$ 1.89	$ (1.47)[(k)]	$ 2.23	$ 6.67

(a) 1,000 shares × ⅔
(b) 1,000 shares + (1,000 shares × ⅓)
(c) (1,000 shares × 8/12) + (1,000 shares × 4/12)
(d) The earnings contingency has no effect on basic EPS because it is not certain that the condition is satisfied until the end of the contingency period (see paragraphs 260-10-45-50 through 45-57). The effect is negligible for the fourth-quarter and full-year computations because it is not certain that the condition is met until the last day of the period.
(e) (0 + 1,000 + 2,000 + 2,000) ÷ 4
(f) Entity A did not have $500,000 year-to-date, after-tax net income at March 31, 20X1. Projecting future earnings levels and including the related contingent shares are not permitted by this Subtopic.
(g) [($600,000 – $500,000) ÷ $100] × 5 shares
(h) Year-to-date, after-tax net income was less than $500,000.
(i) [($700,000 – $500,000) ÷ $100] × 5 shares
(j) (0 + 5,000 + 0 + 10,000) ÷ 4
(k) Loss during the third quarter is due to an extraordinary item; therefore, antidilution rules (see paragraph 260-10-45-17) do not apply.

Excerpt from ASC 260-10

• > Example 12: Computing Year-to-Date Weighted-Average Shares Outstanding

55-85 The following Cases illustrate the guidance in paragraphs 260-10-55-3A through 55-3B for the quarterly and annual computations of basic and diluted EPS for a company with options outstanding (equal to 20,000 incremental shares) that were in the money for the entire year (for simplicity purposes, this Example assumes that the stock price never changed). Case A addresses year-to-date loss, and Case B addresses year-to-date income. Note that in Case A, due to a loss for the period, zero incremental shares are included because the effect would be antidilutive. Note that in Case B, zero shares included due to loss in the period.

• • > Case A: Year-to-Date Loss

55-86 The following tables illustrate the computation of quarterly and year-to-date EPS.

Quarterly	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Income from continuing operations	$ 50,000	$(150,000)	$ 50,000	$(200,000)
Common shares	100,000	100,000	100,000	100,000
Incremental shares	20,000	0[(a)]	20,000	0[(a)]
Basic EPS	$ 0.50	$ (1.50)	$ 0.50	$ (2.00)
Diluted EPS	$ 0.42	$ (1.50)	$ 0.42	$ (2.00)

(a) Due to a loss for the period, zero incremental shares are included because the effect would be antidilutive.

Year-to-Date	**Three Months**	**Six Months**	**Nine Months**	**Full Year**
Income from continuing operations	$ 50,000	$ (100,000)	$ (50,000)	$ (250,000)
Common shares	100,000	100,000	100,000	100,000
Incremental shares	20,000	0[(a)]	0[(a)]	0[(a)]
Basic EPS	$ 0.50	$ (1.00)	$ (0.50)	$ (2.50)
Diluted EPS	$ 0.42	$ (1.00)	$ (0.50)	$ (2.50)

(a) Due to a loss for the period, zero incremental shares are included because the effect would be antidilutive.

• • > Case B: Year-to-Date Income

55-87 The following tables illustrate the computation of quarterly and year-to-date EPS.

Quarterly	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Income from continuing operations	$ (5,000)	$ (5,000)	$ 110,000	$ 200,000
Common shares	100,000	100,000	100,000	100,000
Incremental shares	0[(a)]	0[(a)]	20,000	20,000

Basic EPS	$ (0.05)	$ (0.05)	$ 1.10	$ 2.00
Diluted EPS	$ (0.05)	$ (0.05)	$ 0.92	$ 1.67

(a) Zero shares included due to loss in the period.

Year-to-Date	Three Months	Six Months	Nine Months	Full Year
Income from continuing operations	$ (5,000)	$ (10,000)	$ 100,000	$ 300,000
Common shares	100,000	100,000	100,000	100,000
Incremental shares	0[(a)]	0[(a)]	20,000[(b)]	20,000[(c)]
Basic EPS	$ (0.05)	$ (0.10)	$ 1.00	$ 3.00
Diluted EPS	$ (0.05)	$ (0.10)	$ 0.83	$ 2.50

(a) Zero shares included due to loss in the period.
(b) Nine-month computation: (20 + 20 + 20) ÷ 3
(c) Full-year computation: (20 + 20 + 20 + 20) ÷ 4

Note that if the options had been out of the money in any quarter, zero incremental shares would have been included for that quarter in the year-to-date averaging.

Question 8.3.25

How is the year-to-date diluted EPS denominator calculated when one of the quarterly periods had a loss and there is year-to-date income?

Interpretive response: The EPS denominator is based on the weighted-average number of shares used in each quarterly calculation, not on a discrete calculation of the denominator for the year-to-date period. When there is a loss in one of the quarterly periods included in the year-to-date period, shares that were antidilutive in that quarter because of the loss are included in the denominator of the year-to-date period if they are dilutive. See Example 8.3.15. [260-10-55-3B]

We understand there may be diversity in practice in performing the calculation in this case. Some entities perform a discrete sequencing calculation of the denominator for the year-to-date period, potentially resulting in the inclusion of all shares in a year-to-date period that were previously antidilutive due to either sequencing or a loss.

Example 8.3.15

Year-to-date diluted EPS denominator

ABC Corp. has 100,000 shares and 70,000 RSUs (i.e. potential common shares) outstanding on January 1, Year 2. There is no change to the number of shares or potential common shares outstanding during the period.

Below is information on the quarterly income (loss) and the diluted EPS denominator, using the treasury stock method. No adjustments were necessary to the numerator.

	Q1	Q2	Q3	9 months YTD
Income (loss) from continuing operations	$(500,000)	$650,000	$(100,000)	$50,000
Denominator:				
Common shares	100,000	100,000	100,000	100,000
Incremental shares	-	20,000	-	20,000[1]
	100,000	120,000	100,000	**120,000**

Note:

1. [(20,000 + 20,000 + 20,000) ÷ 3]

The potential common shares are not included in Q1 and Q3 because adding those shares to the loss from continuing operations would be antidilutive. However, there is income in the year-to-date period, and therefore when calculating the year-to-date denominator, the outstanding potential common shares in Q1 and Q3 are included; this is because they were potential common shares as of January 1.

Question 8.3.30

How is year-to-date EPS affected when the settlement conclusion for an instrument differs from the accounting classification?

Background: As discussed in section 6.13, a contract that may be settled in shares or cash at the option of the counterparty is included in diluted EPS based on the settlement outcome that is most dilutive.

This could result in a difference between the accounting for the instrument and its treatment for EPS purposes: an instrument that is recorded in equity for accounting purposes may be treated as cash-settled for EPS purposes, or an instrument treated as an asset/liability for accounting purposes may be treated as share-settled for EPS purposes.

Interpretive response: In these cases, a numerator adjustment is required to adjust for the difference between the accounting classification and the EPS treatment. When calculating year-to-date diluted EPS, the entity determines if the instrument is dilutive based on year-to-date income. This may result in a numerator adjustment (see Question 6.13.10).

The numerator adjustment is calculated for the year-to-date period as a discrete period. However, the denominator for the year-to-date period is generally calculated as the average of the denominators used in each quarterly period. This may result in a mismatch between the numerator and the denominator.
[260-10-55-34]

Question 8.3.40#

When an election to settle a liability-classified share-based payment award in cash is changed to share settlement, what is the effect on quarterly and year-to-date diluted EPS?

Background: ABC Corp., a calendar year SEC registrant, issued warrants to a service provider. The warrants are settleable in common shares and/or cash at ABC's election. The warrants are liability-classified because of ABC's intention to settle, and past practice of settling, similar awards in cash.

Since issuing the warrants in Year 1, for EPS purposes, ABC had presumed the warrants would be cash-settled because it determined it was able to overcome the presumption in paragraph 260-10-45-45A that the contract would be settled in common shares. The evidence that overcame this presumption is based on its financial strength, its ability to borrow, and its stated intent to settle the award in cash. Historically, ABC did not include similar instruments in calculating diluted EPS.

However, on October 1, Year 4, ABC changes its stated intention and will settle all liability-classified warrants in shares. ABC reaches this decision for a variety of reasons, including its current intention to use cash on hand and new bank borrowings to fund acquisitions.

Interpretive response: Generally, an entity is not permitted to adjust its previously reported EPS unless specifically provided for by Topic 260. Topic 260 does not specifically address situations in which an entity changes its stated intention and concludes that it will settle such instruments in shares. In such cases, we believe the calculation of diluted EPS should reflect the change in the settlement assumption on a prospective basis and diluted EPS as reported in prior periods should not be retrospectively adjusted.

Calculations of quarterly diluted EPS after a change

In calculating quarterly diluted EPS after a change in the entity's stated intention, the entity uses the treasury stock method as described in section 4.4.40. When determining the denominator for diluted EPS using the treasury stock method, the entity is required to assume that the securities were converted at the beginning of the quarter (but only to the extent they were actually outstanding during the quarter), and include the resulting incremental shares in the denominator, unless the effect would be antidilutive.

Calculations of year-to-date diluted EPS after a change

In the absence of specific guidance in Topic 260, we believe an entity may elect one of the following approaches when calculating diluted EPS on a year-to-date basis.

— **Approach 1: Apply the treasury stock method prospectively** so that:

  – income available to common shareholders (the numerator) includes the effect of the numerator adjustment (to reverse the mark-to-market adjustment of the liability-classified instrument) from the date the entity changes its stated intent (October 1, Year 1); and

  - the denominator consists of the weighted-average number of shares included in each quarterly diluted EPS calculation. That is, the denominator consists of the weighted average of the shares determined during the first three quarters (which would be zero given the cash-settlement assertion in those quarters), and the last quarter under the treasury stock method.

  This method is consistent with the premise that the change in the settlement assumption affects EPS only on a prospective basis from the date of the change. It is also consistent with the effect on year-to-date calculations of contingently issuable shares which are included in the denominator only on a weighted-average basis. [260-10-45-49]

- **Approach 2: Apply the treasury stock method for the entire period** so that an entity adjusts:
  - income available to common shareholders (the numerator) for the effect of the numerator adjustment as of the beginning of the year; and
  - the denominator based on an assumption that the instruments were exercised at the beginning of the year.

In making these adjustments, the entity assumes the warrants are issued for the entire period they are outstanding (Year 4 year-to-date) consistent with paragraph 260-10-45-42.

Under the second method, the year-to-date diluted EPS calculation is performed apart from any other calculation, and quarterly and year-to-date diluted EPS as reported in prior periods are not retrospectively adjusted.

This second method is consistent with the premise that year-to-date calculations are considered apart from quarterly calculations. For example, an entity with year-to-date income may have excluded in-the-money options or warrants from one or more quarterly diluted EPS calculations because their effect was antidilutive – i.e. there was a loss in those periods. Under paragraph 260-10-55-3B(b), those options or warrants are included in the diluted EPS denominator on a weighted-average basis in the year-to-date calculation if the effect is dilutive. Similarly, contingent shares that were excluded from a quarterly calculation solely because there was a loss from continuing operations are included in the year-to-date calculation unless the effect is antidilutive.

Example 8.3.20

Quarterly EPS calculation – warrants with a down-round feature

ABC Corp., a public company, issues 1,000 warrants that contain a down-round feature.

- The warrants have a 10-year term and permit the holders to buy its common shares for $10 per share and are exercisable at any time.
- Each warrant can be exercised in exchange for 5 common shares.
- The warrants specify that if ABC issues additional common shares for an amount less than $10 per share or issues equity-linked financial instruments

with a strike price below $10 per share, the strike price of the warrants will be reduced to the issuance price of such common shares or the strike price of the equity-linked financial instruments.

— ABC classifies the warrants as equity because it has determined that the warrants meet the conditions for the derivative accounting equity scope exception in paragraph 815-10-15-74(a).

Subsequent to issuing the warrants, ABC issues common shares at $8 per share on the first day of its third quarter of Year 2. Because this subsequent round of financing occurred at a share price below the original strike price of the warrants ($10), the down-round feature is triggered, and the strike price of the warrants is reduced to $8 per share.

As discussed in section 6.18, because the warrants are equity-classified freestanding financial instruments, the value of triggering the down-round feature is treated as a deemed dividend and deducted from income available to common shareholders at the date the feature is triggered in calculating basic EPS. That value is added back in calculating diluted EPS (assuming the effect is dilutive).

EPS calculations – Year 2

The following tables highlight how the down-round feature affects income available to common shareholders, and therefore basic and diluted EPS. The tables assume the following.

— To highlight the effect of the down-round feature, income available to common shareholders before adjustment for the effect of the down-round feature is assumed to be $100,000 in each of the four quarters.

— The warrants were outstanding for all four quarters.

— The value of the effect of triggering the down-round feature is $7,000.

— Common shares outstanding are 100,000.

— The average market price of ABC's common shares for Q1, Q2, Q3, and Q4 was $11.50, $11.50, $9, and $9 per share, respectively.

— ABC uses the treasury stock method to calculate the dilutive effect of the warrants on diluted EPS.

— ABC has no other dilutive instruments.

Basic EPS calculation

Steps		Q1	Q2	Q3[1]	Q4
1 Numerator	Income available to common shareholders before the effect of the down-round feature	$100,000	$100,000	$100,000	$100,000
	Value of the effect of triggering the down-round feature (deemed dividend)	n/a	n/a	(7,000)	n/a

Steps		Q1	Q2	Q3[1]	Q4
	Income available to common shareholders for basic EPS	$100,000	$100,000	$93,000	$100,000
2 Denominator	Common shares outstanding	100,000	100,000	100,000	100,000
3 Basic EPS	Basic EPS	$1.00	$1.00	$0.93	$1.00

Note:
1. The down-round feature is triggered on the first day of this quarter.

Diluted EPS calculation

Step		Q1	Q2	Q3[1]	Q4
1 Identify potential common shares	The warrants are deemed potential common shares.				
2 Determine EPIS (n/a because only one class of potential common shares. Diluted calculation performed)	Income available to common shareholders for basic EPS	$100,000	$100,000	$93,000	$100,000
	Reverse the value of the effect of triggering the down-round feature (reverse the deemed dividend)	n/a	n/a	7,000	n/a
	Income available to common shareholders for diluted EPS (A)	$100,000	$100,000	$100,000	$100,000
	Common shares outstanding (B)	100,652[2]	100,652[2]	100,556[3]	100,556[3]
	(A)/(B)	$0.99	$0.99	$0.99	$0.99
3 Rank	N/A – only one class of potential common shares				
4 Basic EPS	From calculation above	$1.00	$1.00	$0.93	$1.00
5 Diluted EPS	Diluted EPS	$0.99	$0.99	$0.93[4]	$0.99

Notes:

1. The down-round feature is triggered on the first day of this quarter.
2. The 1,000 warrants are assumed to be exercised, resulting in ABC issuing 5,000 common shares [1,000 warrants × 5 common shares per warrant]. This results in assumed proceeds of $50,000 [$10 strike price × 5,000 common shares]. The $50,000 of assumed proceeds are used to repurchase 4,348 common shares [$50,000 ÷ $11.50 avg. market price]. Therefore, common shares outstanding for diluted EPS are 100,652 [100,000 + 5,000 – 4,348].
3. The 1,000 warrants are assumed to be exercised, resulting in ABC issuing 5,000 common shares [1,000 warrants × 5 common shares per warrant]. This results in assumed proceeds of $40,000 [$8 strike price × 5,000 common shares]. The $40,000 of assumed proceeds are used to repurchase 4,444 common shares [$40,000 ÷ $9 avg. market price]. Therefore, common shares outstanding for diluted EPS are 100,556 [100,000 + 5,000 – 4,444].
4. The treasury stock method was antidilutive because income available to common shareholders for diluted EPS divided by common shares outstanding is greater than basic EPS. Therefore, diluted EPS equals basic EPS.

Example 8.3.30
Year-to-date EPS calculation

ABC's net income (loss) available to common shareholders for each quarter and for the nine months year-to-date is as follows.

	Q1	Q2	Q3	Nine months YTD
Income from continuing operations	$5,000,000	$6,500,000	$1,000,000	$12,500,000
Loss from discontinued operations	–	–	(2,000,000)	(2,000,000)
Net income (loss)	**$5,000,000**	**$6,500,000**	**$(1,000,000)**	**$10,500,000**

The number of common shares outstanding on January 1, Year 1 is 5,000,000.

The following transactions and outstanding instruments are also relevant for the first nine months of Year 1.

Instrument	Terms of instrument	Exercise/conversion
12,000 convertible bonds, outstanding as of January 1	— The par value of each bond on the issuance date is $1,000 – i.e. the total principal amount is $12,000,000. — Each bond is convertible at any time before maturity, at the holder's discretion, into 40 common shares. — The bonds bear interest at 5% per annum, payable at the end of	April 1, all of the convertible bonds are converted into common shares.

Instrument	Terms of instrument	Exercise/conversion
	each quarter. The interest expense is tax-deductible.	
800,000 equity-classified convertible preferred shares, outstanding as of January 1	— The preferred shares pay discretionary, noncumulative dividends. The dividend declared on each convertible preferred share is $0.05, payable at the end of each quarter for shares outstanding at that date. — Each share is convertible into one common share.	June 1, 600,000 convertible preferred shares are converted into common shares.
600,000 warrants to buy ABC's common shares, issued on January 1	— Each warrant is converted into one share at an exercise price of $55. — The warrants are classified as equity instruments.	September 1, all of the warrants are exercised.
200,000 common shares, issued for cash on March 1		
1,500,000 options to buy ABC's common shares, issued on July 1	— Each option is converted into one share at an exercise price of $75. — The options are classified as equity instruments.	No options are exercised during the first nine months of Year 1.

ABC's applicable income tax rate is 21%.

The average market prices per common share are as follows.

January 1 – March 31 (Q1)	$49
April 1 – June 30 (Q2)	$60
July 1 – September 30 (Q3)	$67
January 1 – September 1	$57
July 1 – September 1	$65

Basic EPS calculations – Year 1

The basic EPS calculations for the first three quarters in Year 1 and for the year-to-date period are as follows.

Basic EPS

1 Determine the numerator

The numerator is adjusted by the dividend paid on the preferred shares that are classified in equity but that are not common shares.

	Q1	Q2	Q3	Year-to-date
Income from continuing operations available to common shareholders of ABC	$5,000,000	$6,500,000	$1,000,000	$12,500,000
Less: Dividend on preferred shares[1]	(40,000)	(10,000)	(10,000)	(60,000)
Numerator	**$4,960,000**	**$6,490,000**	**$990,000**	**$12,440,000**

Note:

1. In Q1, dividends are based on 800,000 preferred shares – i.e. 800,000 × $0.05. From Q2, dividends consider the conversion of 600,000 preferred shares on June 1 – i.e. 200,000 × $0.05.

2 Determine the denominator

ABC calculates the denominator as follows.

	Number of shares outstanding	Time weighting for the quarter	Weighted-average no. of shares for the quarter	Time weighting for the nine-month period	Weighted-average no. of shares for the nine-month period
Jan. 1 – Feb. 28	5,000,000	2/3	3,333,333		
March 1 – Issue of common shares	200,000				
March 1 – March 31	5,200,000	1/3	1,733,333		
Weighted-average number of shares for Q1			**5,066,666**	3/9	1,688,889
April 1 – Conversion of bonds	480,000				
April 1 – May 31	5,680,000	2/3	3,786,667		
June 1 – Conversion of preferred shares	600,000				
June 1 – June 30	6,280,000	1/3	2,093,333		
Weighted-average number of shares for Q2			**5,880,000**	3/9	1,960,000

	Number of shares outstanding	Time weighting for the quarter	Weighted-average no. of shares for the quarter	Time weighting for the nine-month period	Weighted-average no. of shares for the nine-month period
July 1 – Aug. 31	6,280,000	2/3	4,186,667		
Sept. 1 – Exercise of warrants	600,000				
September 1 – September 30	6,880,000	1/3	2,293,333		
Weighted-average number of shares for Q3			**6,480,000**	3/9	2,160,000
Weighted-average number of shares for the nine-month period				**9/9**	**5,808,889**

3 Determine basic EPS for income from continuing operations

Basic EPS is determined as follows.

	Q1	Q2	Q3	Year-to-date	
Numerator	$4,960,000	$6,490,000	$990,000	$12,440,000	(A)
Denominator	5,066,666	5,880,000	6,480,000	5,808,889	(B)
Basic EPS	**$0.98**	**$1.10**	**$0.15**	**$2.14**	(C) = (A) ÷ (B)
Loss from discontinued operations	–	–	$(2,000,000)	$(2,000,000)	(D)
Basic EPS from discontinued operations	**–**	**–**	**$(0.31)**	**$(0.34)**	(E) = (D) ÷ (B)
Basic EPS from net income	**$0.98**	**$1.10**	**($0.16)**	**$1.80**	(C) – (E)

Diluted EPS calculations

The diluted EPS calculations for each quarter in Year 1 and for the nine-month year-to-date period are as follows.

Diluted EPS

1 Identify potential common shares

The following instruments are potential common shares because they are outstanding for at least part of the period and if they are converted or exercised, common shares will be issued:

- convertible bonds
- convertible preferred shares
- warrants
- stock options

2 For each potential common share, calculate EPIS

EPIS for each potential common share is calculated as follows.

	Q1	Q2	Q3	Year-to-date[v]	Notes
Convertible bonds					i
Adjustments to numerator	$118,500	–	–	$118,500	
Adjustments to denominator	480,000	–	–	160,000	
EPIS	**$0.25**	**N/A**	**N/A**	**$0.74**	
Convertible preferred shares					ii
Adjustments to numerator	$40,000	$10,000	$10,000	$60,000	
Adjustments to denominator	800,000	600,000	200,000	533,334	
EPIS	**$0.05**	**$0.02**	**$0.05**	**$0.11**	
Warrants					iii
Adjustments to numerator	–	–	–	–	
Adjustments to denominator	–	50,000	61,538	37,179	
EPIS	**N/A**	**–**	**–**	**–**	
Stock options	–	–	–	–	iv
EPIS	**N/A**	**N/A**	**N/A**	**N/A**	

Notes:

i. Convertible bonds

Potential adjustment to the numerator for EPIS: Because the bonds are converted by the end of Q1, the adjustment is the after-tax amount of the interest expense:

(interest expense on the convertible loan notes) × (1 – income tax rate) = (12,000,000 × 5% × 1/4) × (1 – 21%) = $118,500

Potential adjustment to the denominator for EPIS: The number of outstanding shares issued on conversion. The adjustment is weighted for the period during which the convertible bonds are outstanding but not converted:

Q1: 12,000 × 40 × 3/3 = 480,000

Year-to-date: 480,000 × 3/9 = 160,000

ii. Convertible preferred shares

Potential adjustment to the numerator for EPIS: The adjustment is the amount of dividends declared on preferred shares for each period:

Q1: 800,000 × $0.05 = $40,000

Q2 and Q3: 200,000 × $0.05 = $10,000

Year-to-date: $40,000 + $10,000 + $10,000 = $60,000

Potential adjustment to the denominator for EPIS: The number of outstanding shares issued on conversion. The adjustment is weighted for the period during which the convertible preferred shares are outstanding but not converted:

Q1: 800,000 × 3/3 = 800,000

Q2: (800,000 × 2/3) + (200,000 × 1/3) = 600,000

Q3: 200,000 × 3/3 = 200,000

Year to date: (800,000 × 3/9) + (600,000 × 3/9) + (200,000 × 3/9) = 533,333.

iii. Warrants

Potential adjustment to the numerator for EPIS: No adjustment is required.

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9) as follows for each period during which the warrants are outstanding before exercise.

	Q2	**Q3**	**Year-to-date[2]**	
Weighted-average number of warrants (and shares to be issued on exercise of warrants)[1]	600,000	400,000	N/A	(A)
Exercise price	$55	$55	N/A	(B)
Assumed proceeds	**$33,000,000**	**$22,000,000**	**N/A**	(C) = (A) × (B)
Average market price of common shares	$60	$65	N/A	(D)
Number of common shares deemed to have been issued	**550,000**	**338,462**	**N/A**	(E) = (C) ÷ (D)
Incremental shares	**50,000**	**61,538**	**37,179**	(A) – (E)

Notes:

1. Weighted-average number of warrants for Q3: 600,000 × 2/3 = 400,000.

   Weighted-average number of warrants for year to date: 600,000 × 8/12 = 400,000.

No adjustment is required in Q1 because in this period the warrants are not in-the-money (exercise price of $55 exceeds average market price for the period of $49); therefore, they are antidilutive (see section 6.9). These do not need to be included in the year-to-date calculation because the reason they were excluded in Q1 is that they were not in-the-money. Had they been excluded in Q1 because they were antidilutive (there was a loss in the quarterly period), if there had been income in the year-to-date period, they would have been included in the year-to-date calculation. [260-10-55-3B]

2. The full year-to-date calculation is not applicable; the denominator adjustment is calculated as the average of the quarters. The year-to-date denominator is calculated as (0 + 50,000 + 61,358) ÷ 3.

iv. Stock options

No adjustment is required in any of the periods because the options are not in-the-money – the exercise price of $75 exceeds the average market price in all of the periods; therefore, they are antidilutive (see section 6.9).

v. Year-to-date EPIS calculation

1. Numerator adjustment is calculated as the sum of the quarters (representing the effect for the entire period). [260-10-55-34]
2. Denominator adjustment: shares are included as the average of the quarterly number of shares that were included. There were no losses in any of the quarters in this example, and therefore there were no shares excluded that need to be added to the year-to-date denominator because of a loss in an interim period. [260-10-55-3 – 55-3B]

3 Rank the potential common shares

For all of the periods, the ranking is as follows.

	EPIS			
Instruments	**Q1**	**Q2**	**Q3**	**YTD**
Share warrants	N/A	–	–	–
Convertible preferred shares	$0.05	$0.02	$0.05	$0.11
Convertible bonds	$0.25	N/A	N/A	$0.74

4 Determine basic EPS from continuing operations

Basic EPS from continuing operations is as follows (see Step 3 of the basic EPS calculation).

	Q1	Q2	Q3	YTD
Basic EPS from continuing operations	$0.98	$1.10	$0.15	$2.14

5 Identify dilutive potential common shares and determine diluted EPS

The effect of each class of potential common shares is calculated one by one, from the most dilutive to the least dilutive, in a sequence and cumulatively. In each sub-step, the 'before' and 'after' EPS amounts are compared.

Q1

	Earnings	Weighted-average no. of shares	Per share	Dilutive?
Basic EPS from continuing operations	$4,960,000	5,066,666	$0.98	
Convertible preferred shares	40,000	800,000		
Subtotal	$5,000,000	5,866,666	$0.85	✓
Convertible bonds	118,500	480,000		
Total	**$5,118,500**	**6,346,666**	$0.81	✓

Q2

	Earnings	Weighted-average no. of shares	Per share	Dilutive?
Basic EPS from continuing operations	$6,490,000	5,880,000	$1.10	
Warrants	–	50,000		
Subtotal	$6,490,000	5,930,000	$1.09	✓
Convertible preferred shares	10,000	600,000		
Total	**$6,500,000**	**6,530,000**	$0.99	✓

Q3

	Earnings	Weighted-average no. of shares	Per share	Dilutive?
Basic EPS from continuing operations	$990,000	6,480,000	$0.15	
Warrants	–	61,538		
Subtotal	$990,000	6,541,538	$0.15	✓
Convertible preferred shares	10,000	200,000		
Total	**$1,000,000**	**6,741,538**	$0.15	✓

Year-to-date

	Earnings	Weighted-average no. of shares	Per share	Dilutive?
Basic EPS from continuing operations	$12,440,000	5,808,889	$2.14	
Warrants	–	37,179[1]		
Subtotal	$12,440,000	5,846,068	$2.13	✓

	Earnings	Weighted-average no. of shares	Per share	Dilutive?
Convertible preferred shares	60,000	533,334[2]		
	$12,500,000	6,379,402	$1.96	✓
Convertible bonds	118,500	160,000[3]		
Total	**$12,618,500**	**6,539,402**	$1.93	✓

Notes:
1. (0 × 3/9) + (50,000 × 3/9) + (61,538 × 3/9) = 37,179.
2. (800,000 × 3/9) + (600,000 × 3/9) + (200,000 × 3/9) = 533,334.
3. (480,000 × 3/9) + (0 × 3/9) + (0 × 3/9) = 160,000.

Therefore, diluted EPS is determined as follows.

	Q1	Q2	Q3	Year-to-date	
Numerator	$5,118,500	$6,500,000	$1,000,000	$12,618,500	(A)
Denominator	6,346,666	6,530,000	6,741,538	6,539,402	(B)
Diluted EPS from continuing operations	**$0.81**	**$1.00**	**$0.15**	**$1.93**	(C) = (A) ÷ (B)
Loss from discontinued operations	–	–	$(2,000,000)	$(2,000,000)	(D)
Diluted EPS from discontinued operations	**–**	**–**	**$(0.30)**	**$(0.31)**	(E) = (D) ÷ (B)
Diluted EPS from net income	**$0.81**	**$1.00**	**$0.15**	**$1.62**	(C) + (E)

Question 8.3.50

How should the two-class method be applied in interim year-to-date periods?

Interpretive response: Topic 260 does not discuss how to apply the two-class method to interim periods. We believe an entity should determine if it needs to allocate earnings to participating securities in the interim year-to-date period based on year-to-date results, independently from the quarterly determination. If the terms of the dividend are based on cumulative information, an independent allocation of year-to-date earnings may be necessary.

Also, as discussed in Question 5.3.80, we believe income should allocated to participating securities on a weighted-average basis for only the period that they were outstanding.

With regard to diluted EPS, an entity uses the more dilutive of the two-class method or the applicable diluted EPS method (treasury stock method, reverse treasury stock method, if-converted method), as discussed in section 5.7.

9. Presentation, disclosure and other matters

Detailed contents

9.1 How the standard works

Presentation and disclosure

Topic 260 requires presentation and disclosures of EPS information for every period for which an income statement is presented. Additional disclosures are required in the current year when transactions have occurred after the reporting date that would have materially changed the number of common shares or potential common shares outstanding if the transaction had occurred before the end of the period.

This section also provides resources for presenting pro forma EPS after a material business combination and in other circumstances.

In this chapter, 'presentation' refers to items presented on the face of the financial statements, and 'disclosure' refers to items included in the notes to the financial statements.

MLPs

The general principles for calculating EPS also apply to an MLP's calculation of earnings per unit (EPU). Topic 260 provides guidance on how to apply those principles to calculating EPU when the MLP treats payments to IDR holders as equity distributions. It also provides guidance specific to calculating EPU after a dropdown transaction in which the general partner (GP) contributes assets to the MLP.

9.2 Presentation and disclosure

9.2.10 General presentation and disclosure

Presentation of basic and diluted EPS

Excerpt from ASC 260-10

> Required EPS Presentation on the Face of the Income Statement

45-2 Entities with simple capital structures, that is, those with only **common stock** outstanding, shall present basic per-share amounts for income from continuing operations and for net income on the face of the income statement. All other entities shall present basic and diluted per-share amounts for income from continuing operations and for net income on the face of the income statement with equal prominence.

45-3 An entity that reports a discontinued operation in a period shall present basic and diluted per-share amounts for that line item either on the face of the income statement or in the notes to the financial statements.

45-4 The terms basic *EPS* and *diluted EPS* are used to identify EPS data to be presented and are not required to be captions used in the income statement. There are no explicit requirements for the terms to be used in the presentation of basic and diluted EPS; terms such as *earnings per common share* and *earnings per common share—assuming* ***dilution***, respectively, are appropriate.

45-5 Per-share amounts not required to be presented by this Subtopic that an entity chooses to disclose shall be computed in accordance with this Subtopic and disclosed only in the notes to financial statements; it shall be noted whether the per-share amounts are pretax or net of tax.

45-6 Paragraph 230-10-45-3 prohibits reporting an amount of cash flow per share.

45-7 EPS data shall be presented for all periods for which an income statement or summary of earnings is presented. If diluted EPS data are reported for at least one period, they shall be reported for all periods presented, even if they are the same amounts as basic EPS. If basic and diluted EPS are the same amount, dual presentation can be accomplished in one line on the income statement.

Basic and diluted EPS for both continuing operations and net income are presented on the face of the income statement with equal prominence for all periods. However, an entity that has only common shares outstanding for all periods presents only basic EPS because the basic and diluted EPS would yield the same results. Nevertheless, if diluted EPS is reported for at least one period, it is reported for all periods presented, even if it equals basic EPS. [260-10-45-2, 45-7]

An entity that presents discontinued operations must also present EPS for discontinued operations. However, it may present this information either on the face of the income statement or in the notes. [260-10-45-3]

As discussed in section 2.2.30, an entity may disclose additional per-share amounts not required by Topic 260, except for cash flows per share. When per-share amounts are reported for items not required by Topic 260, they should be calculated under Topic 260. The disclosure of these amounts is required to state whether they are pretax or net of tax. However, these per-share amounts may only be disclosed in the notes to the financial statements and may not be presented on the face of the financial statements; see discussion on voluntary EPS presentation in section 9.2.30. [260-10-45-5 – 6]

Question 9.2.10

How should EPS information be captioned in the income statement?

Interpretive response: While Topic 260 refers to terms such as 'basic EPS,' 'diluted EPS,' and 'earnings per common share', there is no required terminology for presenting EPS. However, the chosen description must clearly distinguish basic from diluted EPS and present both when diluted EPS is required. [260-10-45-4]

Question 9.2.20

If income from continuing operations is the same as net income, is EPS presented for both?

Interpretive response: No. If income from continuing operations is the same as net income (i.e. there is no discontinuing operations), we believe basic and diluted EPS need only be presented for net income.

Question 9.2.30

If the difference between basic and diluted EPS is not material, is EPS presented for both?

Interpretive response: Yes. EPS is presented for both basic and diluted EPS without regard to the significance of the difference between the two amounts. [260-10-45-7]

Question 9.2.40

If basic and diluted EPS are equal, is EPS presented for both?

Interpretive response: Yes. In some cases, there may be no difference between basic and diluted EPS. For example, this will occur if:

- the only potential common shares are antidilutive and therefore excluded from the calculation of diluted EPS (see section 4.7); or
- there are dilutive potential common shares but rounding creates the same amounts for basic and diluted EPS.

In such cases, the entity is still required to disclose both basic and diluted EPS; however, it may present them in one line item. [260-10-45-7]

Question 9.2.45

If an entity reports comprehensive income in a single continuous financial statement, where in the statement of comprehensive income is EPS reported?

Interpretive response: An entity that reports comprehensive income in a single continuous financial statement presents EPS data after presenting net income and before presenting other comprehensive income information. [220-10-55-7]

Question 9.2.50

Should income available to common shareholders be presented on the face of the income statement?

Interpretive response: According to the SEC, a registrant should report income or loss available to common shareholders *on the face of the income statement* when it is materially different in quantitative terms from reported net income or loss or when it shows significant trends or other qualitative considerations. [SAB Topic 6.B]

We believe a nonregistrant that presents EPS should also present income available to common shareholders on the face of the income statement if it is materially different from net income.

Question 9.2.55

What is 'materially different' for purposes of presenting income available to common shareholders on the face of the income statement?

Interpretive response: The SEC staff has indicated that they generally will not insist on reporting income or loss available to common shareholders on the face of the income statement (see Question 9.2.50) if the amount differs from net income or loss by less than 10%. [SAB Topic 6.B, FN2]

Entities with discontinued operations present both EPS from continuing operations and EPS from net income. In such case, they should determine whether both income or loss from continuing operations available to common shareholders and income or loss available to common shareholders (from net income) are materially different, from a quantitative perspective, from reported income or loss from continuing operations and reported net income or loss, respectively.

Disclosures

Excerpt from ASC 260-10

50-1 For each period for which an income statement is presented, an entity shall disclose all of the following:

a. A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations. The reconciliation shall include the individual income and share amount effects of all securities that affect **earnings per share** (EPS). Example 2 (see paragraph 260-10-55-51) illustrates that disclosure. (See paragraph 260-10-45-3.) An entity is encouraged to refer to pertinent information about securities included in the EPS computations that is provided elsewhere in the financial statements as prescribed by Subtopic 505-10.
b. The effect that has been given to preferred dividends in arriving at **income available to common stockholders** in computing basic EPS.
c. Securities (including those issuable pursuant to contingent stock agreements) that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented. Full disclosure of the terms and conditions of these securities is required even if a **security** is not included in diluted EPS in the current period.

> **Pending Content**
>
> Transition date: (P) June 30, 2027; (N) June 30, 2027 ¦ Transition Guidance: 105-10-65-7
>
> **50-1** For each period for which an income statement is presented, <u>including interim periods,</u> an entity shall disclose all of the following: …
>
> d. <u>The methods used in the diluted EPS computation for each type of dilutive instrument (for example, **treasury stock method**, **if-converted method**, two-class method, or **reverse treasury stock method**).</u>

50-1A Per-share amounts not required to be presented by this Subtopic that an entity chooses to disclose shall be computed in accordance with this Subtopic and disclosed only in the notes to financial statements; it shall be noted whether the per-share amounts are pretax or net of tax. (See paragraph 260-10-45-5.)

50-2 For the latest period for which an income statement is presented, an entity shall provide a description of any transaction that occurs after the end of the most recent period but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) that would have changed materially the number of common shares or potential common shares outstanding at the end of the period if the transaction had occurred before the end of the period. Examples of those transactions include the issuance or acquisition of common shares; the issuance of warrants, **options**, or convertible securities; the resolution of a contingency pursuant to a **contingent stock agreement**; and the conversion or exercise of potential common shares outstanding at the end of the period into common shares.

• > Participating Securities and Undistributed Earnings

55-24 In all of the following circumstances, the participation rights of the securities may be required to be disclosed in accordance with the provisions of Subtopic 505-10, regardless of whether undistributed earnings are allocated to the **participating security**.

Topic 260 requires the following EPS disclosures for each period for which an income statement is presented. Additional disclosures are required for the current period if there have been changes after the reporting date but before the financial statements are issued (available to be issued) that would have materially changed the number of common shares or potential common shares outstanding at the reporting date had the transactions occurred before that date.

Item	Required disclosure	Where disclosed
Numerator [260-10-50-1(a), 260-10-50-1(b)]	— Disclose the amounts used as the numerators (earnings) in calculating basic and diluted EPS.	Notes to financial statements
	— Reconcile these numerators to income from continuing operations. – The reconciliation includes the individual income and per-share effects of all securities that affect EPS. – For basic EPS, disclose the effect given to preferred dividends in arriving at income available to common shareholders.	Notes to financial statements
Denominator [260-10-50-1(a)]	— Disclose the amounts used as the denominators (weighted-average number of shares) in calculating basic and diluted EPS.	Face of income statement
	— Reconcile these denominators to each other. – The reconciliation includes the individual income and per-share effects of each class of securities that affect EPS.	Notes to financial statements
Potential common shares not included in diluted EPS [260-10-50-1(c)]	— Disclose securities (including contingently issuable shares) that could potentially dilute basic EPS in the future, but were not included in the calculation of diluted EPS because they were antidilutive (see section 4.6).	Notes to financial statements

Item	Required disclosure	Where disclosed
	— Disclose the terms and conditions of these securities.	
Recognized subsequent events [260-10-55-12]	If EPS reflects changes in the number of shares due to events after the reporting date (see section 7.2.20), disclose that fact.	Notes to financial statements
Material unrecognized subsequent events [260-10-50-2]	Provide a description of transactions, other than those accounted for retrospectively (see section 7.2), that occur after the reporting date and that would have significantly changed the number of common shares or potential common shares outstanding at the reporting date if those transactions had occurred before the reporting date. Examples of these transactions include: — issuing shares for cash; — issuing shares whose proceeds are used to repay debt or redeemable preferred shares outstanding at the reporting date; — redeeming outstanding common shares; — conversion or exercise of potential common shares outstanding (such as options, warrants or convertible securities) by the holders at the reporting date into common shares — issuing options, warrants or convertible instruments; — achieving conditions that would result in the issuance of contingently issuable shares.	Notes to financial statements
Information about securities included in EPS calculations [260-10-50-1(a)]	An entity is encouraged, but not required, to refer to pertinent information on the terms and conditions of securities that affect the measurement of EPS that appears elsewhere in the notes to the financial statements.	Notes to financial statements
Additional per-share amounts [260-10-45-5]	In addition to basic and diluted EPS, an entity may disclose amounts per share using a reported component of the income statement other than one required by Topic 260. If such amounts are presented, the entity discloses them in the notes and not in the income statement. However, an entity also is required to disclose whether the amounts per share are before or after tax.	Notes to financial statements

In addition to the Topic 260 disclosure requirements, the following table describes EPS disclosure requirements contained in other Subtopics.

Subtopic	Disclosure
250-10	Disclose the effect on EPS from continuing operations and net income for the current period and any periods retrospectively adjusted for a: — change in accounting principle; [250-10-50-1] — change in estimate that affects future periods, and not made each period in the course of ordinary accounting for such items, unless material (retrospective adjustment not applicable); [250-10-50-4] — change in reporting entity. [250-10-50-6] For the correction of an error, disclose any per-share amounts affected for each prior period presented (see also section 9.2.30). [250-10-50-7] These disclosures are generally made together with additional disclosures required by Subtopic 250-10. See chapters 3 and 4 of KPMG Handbook, Accounting changes and error corrections.
505-10	Provide information on whether the diluted EPS calculations include the shares that would be issued if contingently convertible instruments (e.g. preferred shares) were converted (see also Topic 260 disclosures in paragraph above) and state the reasons why or why not. [505-10-50-14] An entity is encouraged to refer to pertinent information about securities included in the EPS calculations that is provided elsewhere in the financial statements, such as: [260-10-50-1, 505-10-50-3] — in summary form, pertinent information about securities – e.g. dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares or terms that may change conversion or exercise prices (excluding standard antidilution provisions); — the number of shares issuable upon conversion, exercise or satisfaction of conditions during at least the most recent fiscal year, and changes to conversion or exercise prices.
718-40	Disclose the EPS treatment of ESOP shares, and, if material, the amount and treatment in the EPS calculation of the tax benefit related to dividends paid to any ESOP. [718-40-50-1]
852-10	Disclose when it is probable that a bankruptcy plan will require the entity to issue common shares or common share equivalents, thereby diluting current equity interests. [852-10-45-16]

Question 9.2.60

Can the numerator reconciliation be presented in the aggregate?

Interpretive response: No. Topic 260 states that the *individual* income and per-share effects of all securities that affect EPS should be included in the reconciliation. Therefore, these should be disclosed for each class of securities individually. [260-10-50-1(a)]

Question 9.2.70

Must an entity disclose the terms of securities that were not included in the EPS calculation?

Interpretive response: Yes. An entity should disclose the terms and conditions of securities that were not included in diluted EPS for any period, but could be dilutive in the future. [260-10-50-1(c)]

Question 9.2.75

Does an entity disclose securities that were not included in the EPS calculation based on the period-end amount or a weighted average?

Interpretive response: Topic 260 does not provide guidance on how to determine the amount of securities to disclose for those that could potentially dilute basic EPS in the future but were not included in the calculation of diluted EPS because they were antidilutive. In our experience, while disclosing the total shares at period end is more common, practice may vary. [260-10-50-1(c)]

Question 9.2.80

If an entity chooses not to present EPS for participating securities, is there anything it should disclose?

Interpretive response: If an entity chooses not to present EPS for participating securities, it must still allocate earnings to all participating securities when calculating basic EPS. The entity should disclose the following, in addition to the general EPS disclosures for common shares.

— Earnings allocated to participating securities as a reduction in income available to common shareholders, similar to a preferred share dividend or other adjustment to net income needed to arrive at net income attributable to common shareholders. [260-10-45-60, 50-1(b)]

- The terms of the participating security – e.g. dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares or terms that may change conversion or exercise prices (excluding standard antidilution provisions). [260-10-55-24, 505-10-50-3]

Question 9.2.90

Are separate disclosures required for each class of common shares even when EPS for all of the classes is identical?

Interpretive response: Yes. As noted in Question 5.4.10, when basic and diluted EPS are identical for each class of common shares, an entity may disclose one basic and diluted number and clearly indicate that it applies to multiple classes of common shares – e.g. basic net income (loss) per Class X and Y common share.

However, in the notes to the financial statements, an entity should provide all required quantitative disclosures for each class of common shares separately and also qualitatively describe that EPS is identical for each class of common shares under the two-class method.

Question 9.2.100

How does an entity disclose EPS information when basic and diluted EPS are equal?

Interpretive response: When basic and diluted EPS are equal, an entity may present only one line in the income statement labelled 'basic and diluted EPS'. [260-10-45-7]

We believe that if basic and diluted EPS are equal, the entity does not need to disclose a reconciliation of the weighted-average number of common shares used in the EPS calculation to the diluted EPS calculation, which would otherwise be required (see section 9.2.10). However, if basic and diluted are the same due to rounding, we believe an entity would disclose the reconciliation.

Question 9.2.105

Does an entity disclose its change of intent when it has a choice of cash or share settlement?

Interpretive response: Yes. As discussed in section 6.13, when an instrument may be settled in cash or shares, the EPS effect depends on whether share settlement is presumed or whether cash settlement is asserted. This assertion is evaluated on an ongoing basis. Any changes in the assertion are reflected in

EPS on a prospective basis. We believe an entity should disclose when such a change is made.

Topic 260's Example 2 (reproduced below) illustrates the disclosures required by Section 260-10-55.

Excerpt from ASC 260-10

• > Example 2: EPS Disclosures

55-51 This Example illustrates the reconciliation of the numerators and denominators of the basic and diluted EPS computations for income from continuing operations and other related disclosures required by paragraph 260-10-50-1 for Entity A in Example 1. Note that Topic 718 has specific disclosure requirements related to share-based compensation arrangements.

Pending Content

Transition date: (P) June 30, 2027; (N) June 30, 2027 ¦ Transition Guidance: 105-10-65-7

55-51 This Example illustrates the reconciliation of the numerators and denominators of the basic and diluted EPS computations for income from continuing operations and other related disclosures required by paragraph 260-10-50-1 for Entity A in Example 1. This disclosure is required in both interim and annual periods. Note that Topic 718 has specific disclosure requirements related to share-based compensation arrangements.

55-52 The following table illustrates the computation of basic and diluted EPS for the year ended 20X1.

	For the Year Ended 20X1		
	Income (Numerator)	**Shares (Denominator)**	**Per-Share Amount**
Income from continuing operations	$ 7,500,000		
Less: Preferred stock dividends	(45,000)		
Basic EPS			
Income available to common stockholders	7,455,000	3,991,666	$ 1.87
Effect of Dilutive Securities			
Warrants		30,768	
Convertible preferred stock	45,000	308,333	
4% convertible debentures	60,000	50,000	
Diluted EPS			
Income available to common stockholders + assumed conversions	$ 7,560,000	4,380,767	$ 1.73

Options to purchase 1,000,000 shares of common stock at $85 per share were outstanding during the second half of 20X1 but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares. The options, which expire on June 30, 20Y1, were still outstanding at the end of year 20X1.

Pending Content

Transition date: (P) June 30, 2027; (N) June 30, 2027 ¦ Transition Guidance: 105-10-65-7

55-52 The following table illustrates the computation of basic and diluted EPS for the year ended 20X1.

[Table unchanged from above]

<u>Diluted EPS was computed using the treasury stock method for warrants and the if-converted method for convertible instruments.</u> Options to purchase 1,000,000 shares …

9.2.20 Interim disclosure considerations

Excerpt from ASC 270-10

> Disclosure of Summarized Interim Financial Data by Publicly Traded Companies

50-1 Many **publicly traded companies** report summarized financial information at periodic interim dates in considerably less detail than that provided in annual financial statements. While this information provides more timely information than would result if complete financial statements were issued at the end of each interim period, the timeliness of presentation may be partially offset by a reduction in detail in the information provided. As a result, certain guides as to minimum disclosure are desirable. (It should be recognized that the minimum disclosures of summarized interim financial data required of publicly traded companies do not constitute a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles [GAAP].) If publicly traded companies report summarized financial information at interim dates (including reports on fourth quarters), the following data should be reported, as a minimum: …

b. Basic and diluted earnings per share data for each period presented, determined in accordance with the provisions of Topic 260.

Excerpt from Reg S-X Rule 10-01

Interim Financial Statements

b. *Other instructions as to content.* The following additional instructions shall be applicable for purposes of preparing interim financial statements:…

2. The basis of the earnings per share computation shall be stated together with the number of shares used in the computation.

If an entity is in the scope of Topic 260, it presents basic and diluted EPS in its interim financial statements.

Section requirements:	260-10-50	270-10-50	Reg S-X Rule 10-01	Other disclosures[1]
Full interim financial statements	✓	✓	✓	✓
Condensed interim financial statements	✓	✓	✓	✗
Summarized interim financial data	✗	✓	✗	✗

Note:

1. This column refers to disclosures required by Subtopics 250-10, 505-10 and 852-10.

Condensed interim financial statements

If an entity presents condensed interim financial statements, it still reports basic and diluted EPS for each period presented. Further, the disclosures in Topic 260 (see section 9.2.10) are required regardless of whether the disclosures are presented for an annual or interim period. [260-10-50-1 – 50-2]

The general principle in Topic 270 is considered in determining the appropriate level of disclosure for an interim period. Under this general principle, condensed interim financial statements are prepared assuming that users have access to the entity's most recent annual financial report, and therefore it is unnecessary for the notes to interim financial statements to provide relatively insignificant updates to information that was reported in the notes in the most recent annual financial statements. Instead, the overriding objective is to ensure that interim financial statements include all information that is relevant to understanding an entity's financial position and performance during the interim period.

Specific disclosure requirements

Topic 270 requires entities in the scope of Topic 260 to present basic and diluted EPS information for all periods presented. [270-10-50-1(b)]

Reg S-X Rule 10-01, which applies to entities that prepare financial statements under SEC Reg S-X, provides additional information that is required to be presented on the *face of the income statement*. [S-X Rule 10-01(b)(2)]

Item	Considerations
EPS applicable to common shares	Both basic and diluted calculations are presented
Dividends declared per share applicable to common shares	For each class of common shares
Basis of the EPS calculation	Income available to common shareholders
Number of shares used in calculation	Weighted-average number of shares for both basic and diluted calculations

In addition to the above Topic 260 and 270 disclosure requirements, EPS disclosure requirements for interim periods are provided in other Subtopics.

Topic (Subtopic)	Disclosure
250-10	Disclose the effect on EPS from continuing operations and net income for the current period and any periods retrospectively adjusted for a: — change in accounting principle; [250-10-50-1] — change in estimate that affects future periods, and not made each period in the course of ordinary accounting for such items, unless material (retrospective adjustment not applicable); [250-10-50-4] — change in reporting entity. [250-10-50-6] For the correction of an error, disclose any per-share amounts affected for each prior period presented (see also section 9.2.30). [250-10-50-7] These disclosures are generally made together with additional disclosures required by Subtopic 250-10. See chapter 5 in KPMG Handbook, Accounting changes and error corrections.
505-10	Provide information on whether the diluted EPS calculations include the shares that would be issued if contingently convertible instruments (e.g. preferred shares) were converted (see also Topic 260 disclosures in section 9.2.10) and state the reasons why or why not. [505-10-50-14] An entity is encouraged to refer to pertinent information about securities included in the EPS calculations that is provided elsewhere in the financial statements, such as: [260-10-50-1] — in summary form, pertinent information about securities – e.g. dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares or terms that may change conversion or exercise prices (excluding standard antidilution provisions); — the number of shares issued upon conversion, exercise or satisfaction of conditions during at least the most recent

Topic (Subtopic)	Disclosure
	fiscal year, and changes to conversion or exercise prices. [505-10-50-3]

9.2.30 Special disclosure situations

Retrospective adjustments

Excerpt from ASC 260-10

• > Restatement of EPS Data

• • > Stock Dividends or Stock Splits

55-12 If the number of common shares outstanding increases as a result of a **stock dividend** or stock split (see Subtopic 505-20) or decreases as a result of a reverse stock split, the computations of basic and diluted EPS shall be adjusted retroactively for all periods presented to reflect that change in capital structure. If changes in common stock resulting from stock dividends, stock splits, or reverse stock splits occur after the close of the period but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the per-share computations for those and any prior-period financial statements presented shall be based on the new number of shares. If per-share computations reflect such changes in the number of shares, that fact shall be disclosed.

• • > Prior-Period Adjustments

55-15 If authoritative literature requires that a restatement of the results of operations of a prior period be included in the income statement or summary of earnings, then EPS data given for the prior period or periods shall be restated. The effect of the restatement, expressed in per-share terms, shall be disclosed in the period of restatement.

When EPS amounts for prior periods are retrospectively adjusted (as discussed in chapter 7), the adjustment is disclosed in the financial statements. The following situations call for retrospective EPS adjustments.

Situation	When this occurs	What to disclose
Change in capital structure [260-10-55-12, S-X Rule 3-04, 505-10-S99-4]	Stock dividend, stock split, reverse stock split	— The retrospective treatment — Explanation of the change[1] — The date the change became effective[1]
Rights issue – bonus element [260-10-55-13 – 55-14]	Issue to existing shareholders a right to purchase shares at a discounted price	For the bonus element, disclosure is similar to a stock dividend

Situation	When this occurs	What to disclose
Prior-period adjustment [260-10-55-15]	— Upon adoption of a new accounting standard that is adopted by way of retrospective adjustment — Upon correction of an error (restatement)	— The adjustment — The effect of the adjustment in per-share terms
Reverse acquisitions and reorganizations under Subtopics 805-40 and 805-50 [805-40-45-3 –5, 805-50-45-3]	— A business combination where the legal acquirer is the accounting acquiree — A business combination between entities under common control	— Information that enables users to understand that the transaction occurred and EPS effects (retrospectively adjusted) [805-10-50-1, 50-5] — Clear indication that financial data of previously separate entities are combined [805-50-45-5] — The nature of and effects on EPS of nonrecurring intra-entity transactions that have not be eliminated under paragraph 805-50-45-3 [805-50-50-2]

Note:

1. Disclosures apply to entities that present financial statements under SEC Regulation S-X. [S-X Rule 3-04, 505-10-S99-1]

Voluntary EPS presentation for other financial statement components

Excerpt from ASC 260-10

> Required EPS Presentation on the Face of the Income Statement

45-5 Per-share amounts not required to be presented by this Subtopic that an entity chooses to disclose shall be computed in accordance with this Subtopic and disclosed only in the notes to financial statements; it shall be noted whether the per-share amounts are pretax or net of tax.

Topic 260 allows an entity to voluntarily present EPS information for other financial statement components not required by Topic 260, except for cash flow information which is specifically precluded by paragraph 230-10-45-3. This other information is provided in the notes only, and not on the face of the financial statements. Whether the amounts presented are pretax or after-tax should be disclosed. Further, an entity should be careful not to include non-GAAP per share measures anywhere in its financial statements; see KPMG Issues In-Depth, Non-GAAP financial measures. [260-10-45-5 – 45-6]

The following table presents examples of per-share information as either required (**R**), voluntary (**V**) or prohibited (**X**).

EPS item	In income statement?	In notes to financial statements?
EPS for discontinued operations [260-10-45-3]	R[1]	R[1]
Cash flow per share [260-10-45-6]	X	X
EPS effect of restructurings [260-10-45-5]	X	V
EPS for participating securities other than common stock [260-10-45-60]	V	V
EPS effect of items that are unusual or infrequently occurring [220-20-45-1, 260-10-45-5]	X	V
Other per-share amounts [260-10-45-5]	X	V

Note:

1. Presentation is required, either on the face of the income statement or in the notes to the financial statements.

Question 9.2.108
Can an entity present EPS for participating securities?

Interpretive response: Yes, an entity may present EPS for participating securities (see chapter 5), either on the face of the financial statements or in the notes. [260-10-56-60]

Question 9.2.110
May a private entity that voluntarily presents EPS also present pro forma EPS?

Interpretive response: Yes. As discussed in section 2.3, a private entity need not provide EPS; however, an entity that is not required by this Subtopic to provide EPS in its financial statements but chooses to do so should follow the requirements of Topic 260. [260-10-15-3]

As a result, a private entity may choose to present EPS under Topic 260, and also may present a pro forma EPS calculation giving effect to all common shares that would be issued – e.g. upon consummation of a planned private placement offering. However, if a private entity chooses to disclose pro forma EPS, it must include this information in the notes to the financial statements and not on the face of its income statement.

Further, if the pro forma EPS differs from diluted EPS, the entity should disclose the differences in the calculations, and note that the pro forma EPS is not in accordance with Topic 260's requirements, so as not to mislead users of the financial statements. For example, differences can occur because diluted EPS under Topic 260 does not include potential common shares that have an antidilutive effect (see section 4.3).

Question 9.2.115

May an entity disclose per-share data for comprehensive income?

Interpretive response: Yes. However, in our experience, entities generally do not display per-share amounts for comprehensive income or the components of other comprehensive income although such disclosure is permitted only in the notes to the financial statements (i.e. it may not be presented on the face of the income statement).

The FASB has indicated that there are conceptual issues involved in reporting comprehensive income that should be addressed before requiring a per-share amount. For example, if an entity elects to report comprehensive income per-share data, the presentation should not be more prominent than that based on net income or loss. In addition, comprehensive income per-share data is calculated under Topic 260 and is disclosed for all periods presented. [FAS 130.BC77]

SEC filings

IPOs and registration statements

Excerpt from SAB Topic 4.D

Earnings Per Share Computations in an Initial Public Offering

Facts: A registration statement is filed in connection with an initial public offering (IPO) of common stock. During the periods covered by income statements that are included in the registration statement or in the subsequent period prior to the effective date of the IPO, the registrant issued for nominal consideration FN1 common stock, options or warrants to purchase common stock or other potentially dilutive instruments (collectively, referred to hereafter as "nominal issuances").

FN1 Whether a security was issued for nominal consideration should be determined based on facts and circumstances. The consideration the entity receives for the issuance should be compared to the security's fair value to determine whether the consideration is nominal.

Prior to the effective date of FASB ASC Topic 260, Earnings Per Share, the staff believed that certain stock and warrants FN2 should be treated as outstanding for all reporting periods in the same manner as shares issued in a stock split or a recapitalization effected contemporaneously with the IPO. The dilutive effect of such stock and warrants could be measured using the treasury stock method.

FN2 The stock and warrants encompasses by the prior guidance were those issuances of common stock at prices below the IPO price and options or warrants with exercise prices below the IPO price that were issued within a one-year period prior to the initial filing of the registration statement relating to the IPO through the registration statement's effective date.

Question 1: Does the staff continue to believe that such treatment for stock and warrants would be appropriate upon adoption of FASB ASC Topic 260?

Interpretive Response: Generally, no. Historical EPS should be prepared and presented in conformity with FASB ASC Topic 260.

In applying the requirements of FASB ASC Topic 260, the staff believes that nominal issuances are recapitalizations in substance. In computing basic EPS for the periods covered by income statements included in the registration statement and in subsequent filings with the SEC, nominal issuances of common stock should be reflected in a manner similar to a stock split or stock dividend for which retroactive treatment is required by FASB ASC paragraph 260-10-55-12. In computing diluted EPS for such periods, nominal issuances of common stock and potential common stock FN3 should be reflected in a manner similar to a stock split or stock dividend.

FN3 The FASB ASC Master Glossary defines potential common stock as "a security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period."

Registrants are reminded that disclosure about materially dilutive issuances is required outside the financial statements. Item 506 of Regulation S-K requires presentation of the dilutive effects of those issuances on net tangible book value. The effects of dilutive issuances on the registrant's liquidity, capital resources and results of operations should be addressed in Management's Discussion and Analysis.

Question 2: Does reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share alter the registrant's responsibility to determine whether compensation expense must be recognized for such issuances to employees?

Interpretive Response: No. Registrants must follow GAAP in determining whether the recognition of compensation expense for any issuances of equity instruments to employees is necessary. FN4 Reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share does not alter that existing responsibility under GAAP.

FN4 As prescribed by FASB ASC Topic 718, Compensation—Stock Compensation.

Often before or during an IPO, the entity issues shares or potential shares (e.g. warrants or options) to existing shareholders and to others for nominal consideration. The SEC staff believes that these issuances should be treated as a stock dividend or a stock split and are subject to retrospective adjustment (see section 7.3). At the same time, if the recipients of the shares include employees, compensation expense may need to be recognized under Topic 718. [SEC FRM 7520.2(b)]

Question 9.2.120

Are share-based payment awards deemed to be issued for nominal consideration when the exercise price is lower than the common share fair value at the grant date?

Interpretive response: Generally, issuances for which compensation cost or other expense has been recognized under Topic 718 are not considered to have been issued for nominal consideration because the consideration for such awards include goods or services. Therefore, even though the exercise price of employee options may be lower than the fair value of the underlying common shares at the date of grant, such an issuance would not necessarily be considered nominal. The SEC staff has indicated that it expects nominal issuances to be limited to certain issuances to investors or promoters. [SEC FRM 7520.2(c)]

Question 9.2.125

Is a stock split that occurs after the reporting date but before the effectiveness of a registration statement reflected in the registration statement?

Interpretive response: If a stock split occurs after the latest reporting date, but before the effective date of a registration statement, the stock split is retroactively reflected for all periods presented in the financial statements included in the registration statement. See also Question 7.3.10.

If the stock split is intended to occur after the effectiveness of the registration statement, pro forma information (including EPS) is included in the filing. [S-X Article 11-01]

Pro forma information

Presentation of pro forma information

A registrant should present pro forma EPS when changes may occur once an IPO becomes effective and the pro forma EPS best demonstrates to investors the capital structure of the registrant going forward. Therefore, the pro forma EPS information could give effect to all common shares that would be issued on the conversion of debt or equity instruments triggered by the pending transaction. [SEC FRM 3420, 3430]

Disclosure of pro forma information

SEC rules require the disclosure of pro forma financial information in situations such as a: [S-X Article 11-01]

— significant business combination;
— security offering to consummate a business combination; or
— disposal of a significant business.

The pro forma information required in these types of situations is the following EPS information. [S-X Article 11-02]

<table>
<tr><th>What</th><th>Where</th><th>How</th></tr>
<tr><td>Basic and diluted EPS from continuing operations (or net income if the entity does not report discontinued operations)</td><td>On face of condensed pro forma income statement</td><td rowspan="3">For transactions involving the issuance of securities, the number of shares used should be based on the weighted-average number of shares outstanding during the period – adjusted to give effect to shares subsequently issued or assumed to be issued had the particular transaction or event taken place at the beginning of the period presented</td></tr>
<tr><td>Basic and diluted EPS from continuing operations before nonrecurring charges or credits directly attributable to the transaction</td><td>On face of condensed pro forma income statement</td></tr>
<tr><td>The number of shares used to calculate such per-share data</td><td>On face of condensed pro forma income statement</td></tr>
<tr><td>If a convertible security is being issued in the transaction, the possible dilution of the pro forma per-share data</td><td>In the notes to the pro forma income statement</td><td>Considering the nature of the instrument and the effect on diluted EPS as discussed in chapter 4</td></tr>
</table>

Other situations that require pro forma information (including pro forma EPS) are:

— an event or transaction that has occurred or is probable, if such disclosure would be material to investors. This may include pro forma information to reflect the use of proceeds of a stock offering or a change in capital structure resulting from conversion of convertible securities upon a planned IPO. See also Question 7.3.10 with regard to a stock split, stock dividend or reverse stock split that is effective after the date the financial statements are issued. [S-X Article 11-01]

— distributions to owners (i.e. dividends) are intended to be paid from the proceeds of an IPO. SAB Topic 1.B.3 provides additional guidance on dividends from offering proceeds. [SEC FRM 3420.2]

Topic 3 of the SEC's Financial Reporting Manual provides additional information on the SEC's requirements for pro forma financial information.

These pro forma requirements are distinct from the pro forma disclosures required by Topic 805, which are described in the KPMG Handbook, Business combinations.

Question 9.2.130

Should pro forma EPS be presented in periods after an IPO?

Interpretive response: No. As discussed above, although pro forma EPS may be presented in the financial statements preceding an IPO, it is generally no longer presented once the IPO has occurred. [SEC FRM 3620]

Question 9.2.140

May pro forma EPS be presented for tracking stock?

Background: Tracking stock is a class of stock referenced to a specific business activity or entity. A registrant may issue multiple tracking stocks with each one tied to a different business activity (see Question 2.2.140).

Interpretive response: The SEC staff permits presentation of pro forma EPS for multiple classes of shares for periods before their legal creation or issuance of shares only in:

— registration statements used to register newly created classes; and
— the proxy materials that address the issuance of multiple classes.

Pro forma amounts are limited to the most recent fiscal year and subsequent interim period of the issuer. The SEC has objected to registrants' presentations that continue to display the pro forma amounts after the class has been created and issued. [2000 AICPA Conf]

Question 9.2.145

Should pro forma EPS be provided in a registration statement covering convertible securities?

Interpretive response: In a registration statement for convertible securities, the SEC staff believes that disclosure of pro forma EPS is important to investors when the proceeds will be used to extinguish existing preferred stock or debt and such extinguishments will have a material effect on EPS. [SAB Topic 3.A]

Other SEC disclosure matters

Question 9.2.150
Should any additional disclosures be provided for tracking stock?

Interpretive response: The SEC staff reviews disclosures about matters affecting tracking stock and expects those disclosures to include information relevant to investors and potential investors in the tracking stock. An entity should describe the ability and likely effects of management and board control over operational and financial aspects of the tracked businesses, including an ability to alter allocations between tracked businesses. [2000 AICPA Conf]

For a discussion of tracking stock, see Question 2.2.140.

Selected quarterly financial data

An SEC registrant is required to disclose in its periodic filings selected quarterly financial data for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included or are required to be included.

This includes both basic and diluted EPS based on: [S-X 229.302(a)(1)]

— income (loss) from continuing operations; and
— net income (loss).

Question 9.2.160
Is an SEC registrant required to reconcile previously reported EPS amounts?

Interpretive response: Yes. An SEC registrant is required to reconcile the EPS disclosed with that previously reported, and to describe the reason for the difference when the EPS data provided is different from the amounts previously reported on the Form 10-Q. This requirement is in the filing (i.e. Form 10-K – selected quarterly financial data) and not necessarily in the financial statements. [SEC S-K 302(a)(2)]

9.3 MLP provisions

Excerpt from ASC 260-10

45-71 This Subsection provides guidance pertaining to the presentation of earnings per unit for master limited partnerships.

> Incentive Distribution Rights That Are a Separate Class of Limited Partner Interest

45-72 Incentive distribution rights that are a separate class of limited partner interest are participating securities because they have a right to participate in earnings with common equity holders. Therefore, current-period earnings shall be allocated to the general partner, limited partner, and incentive distribution right holder using the two-class method to calculate earnings per unit.

> Incentive Distribution Rights That Are Embedded in the General Partner Interest

45-73 Incentive distribution rights that are embedded in the general partner interest are not separate participating securities. However, because the general partner and limited partner interests are separate classes of equity, the two-class method shall be applied in computing earnings per unit for the general partner and limited partner interests.

• > Incentive Distribution Rights That Are a Separate Class of Limited Partner Interest

• • > Distributions

55-103 When calculating earnings per unit under the two-class method for a master limited partnership, net income (or loss) for the current reporting period shall be reduced (or increased) by the amount of available cash that has been or will be distributed to the general partner, limited partners, and incentive distribution right holder for that reporting period. For example, assume a partnership agreement requires the general partner to distribute available cash within 60 days following the end of each fiscal quarter. The master limited partnership is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter. In order to compute earnings per unit for the first quarter, the general partner determines the amount of available cash that will be distributed to the general partner, limited partners, and incentive distribution right holder for that first quarter. The master limited partnership would reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that are allocated to the general partner, limited partners, and incentive distribution right holder in calculating earnings per unit for the first quarter.

• • > Earnings in Excess of Cash Distributions

55-104 Undistributed earnings shall be allocated to the general partner, limited partners, and incentive distribution right holder utilizing the contractual terms of the partnership agreement. The distribution waterfall (that is, a schedule that prescribes distributions to the various interest holders at each threshold) for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed for the period presented. The undistributed earnings shall be allocated to the incentive distribution right holder based on the contractual participation rights of the incentive distribution right to share in current period earnings. Therefore, if the partnership agreement includes a specified threshold as described in paragraph 260-10-55-30, a master limited partnership shall not allocate undistributed earnings to the incentive distribution right holder once the specified threshold has been met.

55-105 In determining whether a specified threshold exists, a master limited partnership shall evaluate whether distributions to the incentive distribution right holder would be contractually limited to available cash as defined in the partnership agreement if all earnings for the period were distributed. For example, if the partnership agreement contractually limits distributions to the incentive distribution right holder to the holder's share of available cash as defined in the partnership agreement, then the specified threshold for the current reporting period would be the holder's share of available cash that has been or will be distributed for that reporting period. The master limited partnership would not allocate undistributed earnings to the incentive distribution right holder because the holder's share of available cash is the maximum amount that the incentive distribution right holder would be contractually entitled to receive if all earnings for the current reporting period were distributed. However, if the partnership agreement is silent or does not explicitly limit distributions to the incentive distribution right holder to available cash, then the master limited partnership would allocate undistributed earnings to the incentive distribution right holder utilizing the distribution waterfall for available cash specified in the partnership agreement.

• • > Cash Distributions in Excess of Earnings

55-106 Any excess of distributions over earnings shall be allocated to the general partner and limited partners based on their respective sharing of losses specified in the partnership agreement (that is, the provisions for allocation of losses to the partners' capital accounts for the period presented). If the incentive distribution right holders do not share in losses, the excess of distribution over earnings amount would not be allocated to the incentive distribution right holders. However, if the incentive distribution right holders have a contractual obligation to share in the losses of the master limited partnership on a basis that is objectively determinable (as described in paragraph 260-10-45-68), the excess of distributions over earnings shall be allocated to the general partner, limited partners, and incentive distribution right holders based on their respective sharing of losses specified in the partnership agreement for the period presented.

• > Incentive Distribution Rights That Are Embedded in the General Partner Interest

• • > Distributions

55-107 When calculating earnings per unit under the two-class method for a master limited partnership, net income (or loss) for the current reporting period shall be reduced (or increased) by the amount of available cash that has been or will be distributed to the general partner (including the distribution rights of the embedded incentive distribution rights) and limited partners for that reporting period. For example, assume that a partnership agreement requires the general partner to distribute available cash within 60 days following the end of each fiscal quarter. The master limited partnership is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter. In order to compute earnings per unit for the first quarter, the general partner determines the amount of available cash that will be distributed to the general partner and limited partners for that first quarter. The master limited partnership would reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that are allocated to the general partner (including the distribution rights of the embedded incentive distribution rights) and limited partners in calculating earnings per unit for the first quarter.

• • > Earnings in Excess of Cash Distributions

55-108 Undistributed earnings shall be allocated to the general partner (including the distribution rights of the embedded incentive distribution rights) and limited partners utilizing the contractual terms of the partnership agreement. The distribution waterfall for available cash specified in the partnership agreement contractually mandates the way in which earnings are distributed for the period presented. The undistributed earnings shall be allocated to the general partner (with respect to the distribution rights of an embedded incentive distribution right) based on the contractual participation rights of the incentive distribution right to share in current period earnings. Therefore, if the partnership agreement includes a specified threshold as described in paragraph 260-10-55-30, a master limited partnership shall not allocate undistributed earnings to the general partner (with respect to the distribution rights of an embedded incentive distribution right) once the specified threshold has been met. --

55-109 In determining whether a specified threshold exists, a master limited partnership shall evaluate whether distributions to the general partner (with respect to the distribution rights of an embedded incentive distribution right) would be contractually limited to available cash as defined in the partnership agreement if all earnings for the period were distributed. For example, if the partnership agreement contractually limits distributions to the general partner (with respect to the distribution rights of an embedded incentive distribution right) to the holder's share of available cash as defined in the partnership agreement, then the specified threshold for the current reporting period would be the general partner's share (with respect to the distribution rights of an embedded incentive distribution right) of available cash that has been or will be distributed for that reporting period. The master limited partnership would not allocate undistributed earnings to the general partner (with respect to the distribution rights of an embedded incentive distribution right) because the general partner's share (with respect to the distribution rights of an embedded incentive distribution right) of available cash is the maximum amount that the general partner (with respect to the distribution rights of an embedded incentive distribution right) would be contractually entitled to receive if all earnings for the current reporting period were distributed. However, if the partnership agreement is silent or does not explicitly limit distributions to the general partner (with respect to the distribution rights of an embedded incentive distribution right) to available cash, then the master limited partnership would allocate undistributed earnings to the general partner (with respect to the distribution rights of an embedded incentive distribution right) utilizing the distribution waterfall for available cash specified in the partnership agreement.

• • > Cash Distributions in Excess of Earnings

55-110 Any excess of distributions over earnings shall be allocated to the general partner and limited partners based on their respective sharing of losses specified in the partnership agreement for the period presented.

9.3.10 Overview

The MLP Subsections of Topic 260 apply only when an MLP accounts for payments to IDR holders as equity distributions (see Question 2.2.110). These Subsections clarify how the general EPS requirements in Topic 260 apply to the calculation of EPU (the MLP's equivalent of EPS) when such equity distributions exist.

Typically, an MLP issues multiple classes of securities consisting of common units held by limited partners (LPs), a general partner (GP) interest, and IDRs (generally provided to the GP). The IDRs may be a separate class of nonvoting limited partner interest that the GP initially holds but then may transfer or sell while retaining the GP interest. The IDR may also be embedded in the GP interest. [260-10-15-5]

An MLP is generally required to distribute all of its available cash (as defined in the partnership agreement) to the GP and the LPs at the end of its reporting period. This distribution is made according to a waterfall schedule. In addition, the waterfall schedule generally includes incentive distributions to the IDR holders when certain thresholds are met. [260-10-5-4]

The MLP applies the two-class method of calculating EPU under Topic 260 because the GP, LPs and IDR holders each participate differently in the distribution of available cash based on the contractual rights in the partnership agreement. This is so even if the IDR is embedded in the GP interest. [260-10-45-72]

9.3.20 Calculating EPU

When calculating EPU, an MLP adjusts net income (or loss) for the period for available cash that has been or will be distributed to the GP, LP and IDRs, similar to allocating dividends declared or accumulated to participating securities when calculating EPS.

How an MLP calculates EPU depends on whether the IDRs are a separate class of LP interest or are embedded in the GP interest. However, in either case, the effect on the LP (not the IDR) is the same. [260-10-55-103, 55-110]

IDR is a separate class of LP interest

If the IDR is a separate class of LP interest: [260-10-55-103 – 106]

— available cash to be distributed to each of the GP, LP and IDR holders is deducted from net income (or loss) to arrive at income attributable to the partnership interest; and

— undistributed earnings and losses are allocated among the GP, LP and IDR holders according to the terms of the partnership agreement. If the IDR is subject to a maximum threshold, undistributed earnings are allocated only up to the amount of the threshold. If the IDR does not share in the MLP's losses, only undistributed earnings are allocated to the IDR and not losses.

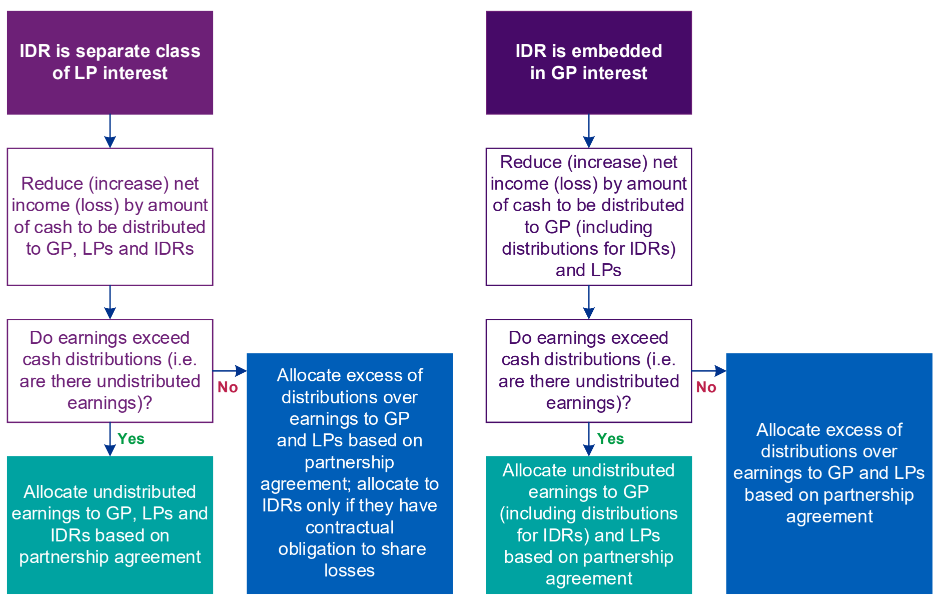
IDR is embedded in GP interest

If the IDR is embedded in the GP interest: [260-10-55-107 – 110]

— available cash to be distributed to each of the GP and LPs is deducted from net income (or loss) to arrive at income attributable to the partnership interest. Distributions to the IDR are included in the distributions to the GP; and

— undistributed earnings and losses are allocated among the GP and LPs according to the terms of the partnership agreement, and the GP interest includes the IDR interest. If the agreement limits the GP's interest to the holder's share of available cash (as defined in the agreement), undistributed earnings are not allocated to the GP's interest in the IDR.

These requirements are depicted in the following decision trees.



Question 9.3.10

How should an MLP account for distributions of available cash when the distribution is required to be made after the reporting date?

Background: An MLP agreement may call for the distribution of available cash 60 days after quarter-end, but the entity is required to file financial statements 45 days after quarter-end.

Interpretive response: Using the background example, allocating undistributed earnings (losses), the MLP first reduces net income (or loss) for the distributions that will be made subsequent to quarter-end. This is similar to the way dividends declared or earned, but not yet paid, are treated when calculating EPS. [260-10-55-103, 55-107]

Question 9.3.20

How should an MLP allocate undistributed losses (cash distributions over earnings) to an IDR?

Interpretive response: This depends on whether the IDR is embedded in the GP interest.

— **IDR is embedded in the GP interest.** The MLP allocates the undistributed losses between the GP and the LPs. [260-10-55-110]

— **IDR is separate from the GP interest.** The MLP allocates the undistributed losses based on the terms of the partnership agreement. If the partnership agreement provides for the IDR to share in the losses of the MLP, undistributed losses are allocated to the IDR. This is similar to allocating losses to a participating security when calculating EPS. [260-10-55-106]

Question 9.3.30

How should EPU calculations be made in year-to-date and annual periods?

Interpretive response: In contrast to EPS calculations, we believe that year-to-date EPU calculations for MLPs should be made independently of the quarterly calculations. This is the same for annual EPU calculations.

Example 9.3.10

EPU calculation for MLP when a threshold exists for distribution of excess earnings

MLP partnership has 5,000 Common Units outstanding at January 1, Year 1.

— 500 units are held by the GP, and 4,500 units are held by the LP.

— There are 1,000 IDRs that are a separate LP interest.

— The partnership agreement provides for net income (loss) to be allocated to the GP and LP according to their partnership interests after giving effect of the IDRs.

— IDR holders share in losses of MLP. However, IDR holders' right to undistributed losses is not limited to their share of available cash.

— The MLP partnership uses a threshold for distribution of excess earnings to IDR holders based on the waterfall schedule below.

— The partnership agreement requires MLP to distribute all available cash (as defined in the agreement) within 60 days after quarter-end.

— No additional units or IDRs were issued during the year.

The following are MLP's net income and available cash for the first quarter of Year 1.

	First quarter
Net income	$100,000
Available cash	**$ 80,000**

The following is the waterfall schedule of available cash distribution per the agreement.

	Distrib. per common unit (LPs)	Waterfall percentage			Cumulative distribution by interest			
		LPs	GP	IDRs	LPs	GP	IDRs	Total
1st threshold	$0.50	90%	10%	-%	$4,500	$500	$ -	$5,000
2nd threshold	**$0.60**	**80%**	**5%**	**15%**	**$6,900**	**$650**	**$450**	**$8,000**
Thereafter	**N/A**	**70%**	**2%**	**28%**				

The calculation of EPU, based on the steps discussed in chapter 5 (steps are adapted for an MLP) are as follows.

Basic EPS calculation – Year 1

Step A: Adjust net income for distributions of cash

Net income		**$100,000**
Less: Distributions of available cash		
To IDR holders[1]	(20,610)	
To GP[2]	(2,090)	
To LPs[3]	(57,300)	
Total		**(80,000)**
Remaining earnings		**$20,000**

Notes:

1. $450 cumulative IDR distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 28% = $20,610.
2. $650 cumulative GP distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 2% = $2,090.
3. $6,900 cumulative GP distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 70% = $57,300.

Step B: Notionally allocate remaining earnings to the different classes of units

	LPs	GP	IDRs
Units outstanding	4,500	500	1,000
Remaining earnings allocated to each class of units	$15,000 ($20,000 × 4,500 ÷ 6,000)	$1,667 ($20,000 × 500 ÷ 6,000)	$3,333 ($20,000 × 1,000 ÷ 6,000)

Step C: Determine total earnings attributable to each class of units

	LPs	GP	IDRs
Distributions of available cash	$57,300	$2,090	$20,610
Remaining earnings allocated to each class of units	15,000	1,667	3,333
Total earnings attributable to class of unit	**$72,300**	**$3,757**	**$23,943**

Step D: Divide total earnings attributable to class of units by number of weighted-average outstanding units for the period

	LPs	GP	IDRs
Total earnings attributable to class of unit	$72,300	$3,757	$23,943
Units outstanding	4,500	500	1,000
Basic EPU	**$16.07**	**$7.51**	**$23.94**

Example 9.3.20
EPU calculation for MLP when a threshold does not exist for distribution of excess earnings

MLP partnership has 5,000 Common Units outstanding at January 1, Year 1.

— 500 units are held by the GP, and 4,500 units are held by the LP.

— There are 1,000 IDRs that are a separate LP interest.

— The partnership agreement provides for net income (loss) to be allocated to the GP and LP according to their partnership interests after giving effect to the IDRs.

— IDR holders share in losses of MLP. However, the IDR holders' right to undistributed losses is not limited to their share of available cash.

— MLP does not use a threshold for distribution of excess earnings to IDR holders.

— The partnership agreement requires MLP to distribute all available cash (as defined in the agreement) within 60 days after quarter-end.

— No additional units or IDRs were issued during the year.

The following are MLP's net income and available cash for Q1 of Year 1.

	Q1
Net income	$100,000
Available cash	**$ 80,000**

The following is the waterfall schedule of available cash distribution per the agreement. MLP does not use a threshold for distribution of excess earnings to IDR holders.

	Distrib. per common unit (LPs)	Waterfall percentage		
		LPs	GP	IDRs
Allocation of earnings and distributions	**N/A**	**70%**	**2%**	**28%**

The calculation of EPU, based on the steps discussed in chapter 5 (adapted for an MLP) are as follows.

Basic EPS calculation – Year 1

Step A: Adjust net income for distributions of cash

Net income		**$100,000**
Less: Distributions of available cash		
To IDR holders[1]	(20,610)	
To GP[2]	(2,090)	
To LPs[3]	(57,300)	
Total		**(80,000)**
Remaining earnings		**$20,000**

Notes:

1. $450 cumulative IDR distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 28% = $20,610.
2. $650 cumulative GP distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 2% = $2,090.
3. $6,900 cumulative LP distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 70% = $57,300.

Step B: Notionally allocate remaining earnings to the different classes of units

	LPs	GP	IDRs
Waterfall percentage	70%	2%	28%
Remaining earnings allocated to each class of units	$14,000 (70% × $20,000)	$400 (2% × $20,000)	$5,600 (28% × $20,000)

Step C: Determine total earnings attributable to each class of units

	LPs	GP	IDRs
Distributions of available cash	$57,300	$2,090	$20,610
Remaining earnings allocated to each class of units	14,000	400	5,600
Total earnings attributable to class of unit	**$71,300**	**$2,490**	**$26,210**

Step D: Divide total earnings attributable to each class of units by number of weighted-average outstanding units for the period

	LPs	GP	IDRs
Total earnings attributable to class of unit	$71,300	$2,490	$26,210
Units outstanding	4,500	500	1,000
Basic EPU	**$15.84**	**$4.98**	**$26.21**

Example 9.3.30

EPU calculation for MLP when IDR does not participate in losses

MLP partnership has 5,000 Common Units outstanding at January 1, Year 1.

- 500 units are held by the GP, and 4,500 units are held by the LP.
- There are 1,000 IDRs that are a separate LP interest.
- The partnership agreement provides for net income (loss) to be allocated to the GP and LP according to their partnership interests after giving effect to the IDRs.
- IDR holders do not share in losses of MLP.
- The partnership agreement requires MLP to distribute all available cash (as defined in the agreement) within 60 days after quarter-end.
- No additional units or IDRs were issued during the year.

The following are MLP's net income and available cash for Q1 of Year 1.

	Q1
Net Income	$50,000
Available cash	**$80,000**

The following is the waterfall schedule of available cash distribution per the agreement.

	Distrib. per common unit (LPs)	Waterfall percentage			Cumulative distribution by interest			
		LPs	GP	IDRs	LPs	GP	IDRs	Total
1st threshold	$0.50	90%	10%	-%	$4,500	$500	$ -	$5,000
2nd threshold	**$0.60**	**80%**	**5%**	**15%**	**$6,900**	**$650**	**$450**	**$8,000**
Thereafter	**N/A**	**70%**	**2%**	**28%**				

The calculation of EPU, based on the steps discussed in chapter 5 (adapted for an MLP) are as follows.

Basic EPS calculation – Year 1

Step A: Adjust net income for distributions of cash

Net income		**$50,000**
Less: Distributions of available cash		
To IDR holders[1]	(20,610)	
To GP[2]	(2,090)	
To LPs[3]	(57,300)	
Total		**(80,000)**
Remaining losses		**$(30,000)**

Notes:

1. $450 cumulative IDR distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 28% = $20,610.
2. $650 cumulative GP distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 2% = $2,090.
3. $6,900 cumulative LP distribution for 2nd threshold + distribution per waterfall calculation ($80,000 – $8,000) × 70% = $57,300.

Step B: Notionally allocate remaining earnings to the different classes of units

	LPs	GP	IDRs
Units outstanding	4,500	500	1,000
Remaining losses allocated to each class of units	$(27,000) ($(30,000) × 4,500 ÷ 5,000)	$(3,000) ($(30,000) × 500 ÷ 5,000)	$ -

Step C: Determine total earnings attributable to each class of units

	LPs	GP	IDRs
Distributions of available cash	$57,300	$2,090	$20,610
Remaining earnings (losses) allocated to each class of units	(27,000)	(3,000)	-
Total earnings attributable to class of unit	**$30,300**	**$(910)**	**$20,610**

Step D: Divide total earnings attributable to each class of units by number of weighted-average outstanding units for the period

	LPs	GP	IDRs
Total earnings (loss) attributable to class of unit	$30,300	$(910)	$20,610
Units outstanding	4,500	500	1,000
Basic EPU	**$6.73**	**$(1.82)**	**$20.61**

9.3.30 Dropdown transactions

Excerpt from ASC 260-10

50-3 In the period in which a **dropdown** transaction occurs that is accounted for under the Transactions Between Entities Under Common Control Subsections of Subtopic 805-50, a reporting entity shall disclose in narrative format how the rights to the earnings (losses) of the transferred net assets differ before and after the dropdown transaction occurs for purposes of computing earnings per unit under the two-class method.

• > Presentation of Historical Earnings per Unit after a Dropdown Transaction Accounted for as a Transaction between Entities under Common Control

55-111 A general partner may transfer net assets to a master limited partnership as part of a **dropdown** transaction that occurs after formation of the master limited partnership. If the master limited partnership accounts for the dropdown transaction under the Transactions Between Entities Under Common Control Subsections of Subtopic 805-50, in calculating the historical earnings per unit under the two-class method, the earnings (losses) of the transferred net assets before the date of the dropdown transaction should be allocated entirely to the general partner. In that circumstance, the previously reported earnings per unit of the limited partners for periods before the date of the dropdown transaction should not change as a result of the dropdown transaction.

A dropdown transaction occurs when a GP transfers assets to its MLP. An MLP typically accounts for such an asset transfer under Subtopic 805-50 as a transaction between entities under common control. That Subtopic requires that the recipient's results of operations for the period in which the transfer occurs be reported as if the transfer occurred at the beginning of the period. If there are nonrecurring intra-entity transactions involving long-term assets and liabilities, they are not eliminated for EPU purposes. [805-50-45-2 – 45-3]

Despite this accounting treatment under Subtopic 805-50, Topic 260 provides that when the MLP calculates EPU using the two-class method, it allocates all earnings or losses from the transferred net assets before the dropdown transaction date to the GP and none to the LPs. Therefore, the previously reported EPU of the LPs is not affected by a dropdown transaction of assets to the MLP from the GP. [260-10-55-111]

Question 9.3.40

Do Topic 260's dropdown provisions apply when an entity under common control with the GP transfers assets to an MLP?

Background: In the current year, Limited Partnership (which is under common control with MLP and its GP) transfers (or drops down) net assets to MLP in a transaction accounted for as a transaction between entities under common control. MLP must retrospectively adjust its financial statements to reflect the dropdown transaction as if it occurred on the earliest date during which the entities were under common control.

Interpretive response: Yes. We believe the earnings of the transferred net assets before the date of the dropdown transaction should be allocated entirely to the GP when calculating the prior period EPU. Although an entity other than the GP transferred the net assets to the MLP, because the entity was under common control with the GP, we believe the guidance in paragraph 260-10-55-111 applies. Therefore, the previously reported EPU of the LPs for the period before the date of the dropdown transaction should not change as a result of the dropdown transaction.

9.3.40 MLP disclosure requirements

In addition to the disclosure requirements described in section 9.2, which apply to an MLP for a dropdown transaction, the MLP should disclose how the rights to the earnings (losses) of the transferred net assets differ before and after the dropdown transaction. [260-10-50-3]

9.4 EPS requirements in other Topics

The following ASC Sections also include specific EPS guidance (included elsewhere in this Handbook).

Specific guidance	ASC Section	Affects
Presentation of unusual or infrequent items	220-20-45	Presentation
Physically settled forward purchase contracts for a fixed number of shares for cash	480-10-45	Basic EPS
Contingently convertible instruments	505-10-50	Disclosure requirements
Contingently convertible instruments	505-10-50	Disclosure requirements
Rabbi trusts	710-10-45	Basic and diluted EPS
Share-based payment arrangements, nonvested shares and similar equity instruments	718-10-45	Diluted EPS
Employee stock ownership plans	718-40-45, 718-40-50	— Basic and diluted EPS — Disclosure requirements
Reverse acquisitions	805-40-45	Basic EPS
Research and development arrangements	810-30-45	Basic and diluted EPS
Reorganizations	852-10-45	Disclosure requirements

In addition, Sections 260-10-S99-2 and 480-10-S99-3A include SEC guidance related to EPS for certain preferred shares.

10. Select Topic 260 illustrations

Excerpt from ASC 260-10

• > Example 1: Computation of Basic and Diluted EPS and Income Statement Presentation

55-38 This Example illustrates the quarterly and annual computations of basic and diluted EPS in the year 20X1 for Entity A, which has a complex capital structure. The control number used in this Example (and in Example 2) is income from continuing operations. Paragraph 260-10-55-49 illustrates the presentation of basic and diluted EPS on the face of the income statement. The facts assumed are as follows:

a. Average market price of common stock. The average market prices of common stock for the calendar-year 20X1 were as follows.

First quarter	$59
Second quarter	$70
Third quarter	$72
Fourth quarter	$72

b. The average market price of common stock from July 1 to September 1, 20X1 was $71.
c. Common stock. The number of shares of common stock outstanding at the beginning of 20X1 was 3,300,000. On March 1, 20X1, 100,000 shares of common stock were issued for cash.
d. Convertible debentures. In the last quarter of 20X0, 4 percent convertible debentures with a principal amount of $10,000,000 due in 20 years were sold for cash at $1,000 (par). Interest is payable semiannually on November 1 and May 1. Each $1,000 debenture is convertible into 20 shares of common stock. No debentures were converted in 20X0. The entire issue was converted on April 1, 20X1, because the issue was called by Entity A.
e. Convertible preferred stock. In the second quarter of 20X0, 600,000 shares of convertible preferred stock were issued for assets in a purchase transaction. The quarterly dividend on each share of that convertible preferred stock is $0.05, payable at the end of the quarter. Each share is convertible into one share of common stock. Holders of 500,000 shares of that convertible preferred stock converted their preferred stock into common stock on June 1, 20X1.
f. Warrants. Warrants to buy 500,000 shares of common stock at $60 per share for a period of 5 years were issued on January 1, 20X1. All outstanding warrants were exercised on September 1, 20X1.
g. Options. Options to buy 1,000,000 shares of common stock at $85 per share for a period of 10 years were issued on July 1, 20X1. No options

were exercised during 20X1 because the exercise price of the options exceeded the market price of the common stock.

h. Tax rate. The tax rate was 40 percent for 20X1.

55-39 The following table illustrates the income (loss) from continuing operations.

Year 20X1	Income (Loss) from Continuing Operations[a]	Net Income (Loss)
First quarter	$ 3,000,000	$ 3,000,000
Second quarter	4,500,000	4,500,000
Third quarter	500,000	(1,500,000)[b]
Fourth quarter	(500,000)	(500,000)
Full year	$ 7,500,000	$ 5,500,000

(a) This is the control number (before adjusting for preferred dividends). See paragraph 260-10-45-18.
(b) Entity A had a $2 million loss on discontinued operations (net of tax) in the third quarter.

55-40 The following tables illustrate calculation of basic EPS for the first quarter.

	First Quarter 20X1
Basic EPS Computation	
Net income	$3,000,000
Less: Preferred stock dividends	(30,000)[a]
Income available to common stockholders	$2,970,000

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
January 1–February 28	3,300,000	⅔	2,200,000
Issuance of common stock on March 1	100,000		
March 1–March 31	3,400,000	⅓	1,133,333
Weighted-average shares			3,333,333

Basic EPS $0.89

The equation for computing basic EPS is:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

(a) 600,000 shares × $0.05

55-41 The following table illustrates calculation of diluted EPS for the first quarter.

First Quarter 20X1

Diluted EPS Computation

Income available to common stockholders		$ 2,970,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	$ 30,000[a]	
Interest on 4% convertible debentures	60,000[b]	
Effect of assumed conversions		90,000
Income available to common stockholders + assumed conversions		$ 3,060,000
Weighted-average shares		3,333,333
Plus: Incremental shares from assumed conversions		
Warrants	–[c]	
Convertible preferred stock	600,000	
4% convertible debentures	200,000	
Dilutive potential common shares		800,000
Adjusted weighted-average shares		4,133,333

Diluted EPS $0.74

The equation for computing diluted EPS is:

$$\frac{\text{Income available to common stockholders + Effect of assumed conversions}}{\text{Weighted-average shares + Dilutive potential common shares}}$$

(a) 600,000 shares × $0.05
(b) ($10,000,000 × 4%) ÷ 4; less taxes at 40%
(c) The warrants were not assumed exercised because they were antidilutive in the period ($60 exercise price > $59 average price).

55-42 The following tables illustrate calculation of basic EPS for the second quarter.

Second Quarter 20X1

Basic EPS Computation

Net income	$4,500,000
Less: Preferred stock dividends	(5,000)[a]
Income available to common stockholders	$4,495,000

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
April 1	3,400,000		
Conversion of 4% debentures on April 1	200,000		
April 1–May 31	3,600,000	⅔	2,400,000
Conversion of preferred stock on June 1	500,000		
June 1–June 30	4,100,000	⅓	1,366,667
Weighted-average shares			3,766,667

Basic EPS $1.19

The equation for computing basic EPS is:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

(a) 100,000 shares × $0.05

55-43 The following table illustrates calculation of diluted EPS for the second quarter.

Second Quarter 20X1

Diluted EPS Computation		
Income available to common stockholders		$4,495,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	$5,000[(a)]	
Effect of assumed conversions		5,000
Income available to common stockholders + assumed conversions		$4,500,000
Weighted-average shares		3,766,667
Plus: Incremental shares from assumed conversions		
Warrants	71,429[(b)]	
Convertible preferred stock	433,333[(c)]	
Dilutive potential common shares		504,762
Adjusted weighted-average shares		4,271,429

Diluted EPS $1.05

The equation for computing diluted EPS is:

$$\frac{\text{Income available to common stockholders + Effect of assumed conversions}}{\text{Weighted-average shares + Dilutive potential common shares}}$$

(a) 100,000 shares × $0.05
(b) $60 × 500,000 = $30,000,000; $30,000,000 ÷ $70 = 428,751; 500,000 – 428,571 = 71,429 shares OR [($70 – $60) ÷ $70] × 500,000 shares = 71,429 shares
(c) (600,000 shares × 2/3) + (100,000 shares × 1/3)

55-44 The following tables illustrate calculation of basic EPS for the third quarter.

Third Quarter 20X1

Basic EPS Computation	
Income from continuing operations	$ 500,000
Less: Preferred stock dividends	(5,000)
Income available to common stockholders	495,000
Loss on discontinued operations	(2,000,000)
Net loss available to common stockholders	$ (1,505,000)

Dates Outstanding	**Shares Outstanding**	**Fraction of Period**	**Weighted-Average Shares**
July 1–August 31	4,100,000	⅔	2,733,333
Exercise of warrants on September 1	500,000		
September 1–September 30	4,600,000	⅓	1,533,333
Weighted-average shares			4,266,666

Basic EPS	
Income from continuing operations	$ 0.12
Loss on discontinued operations	$ (0.47)
Net loss	$ (0.35)

The equation for computing basic EPS is:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

55-45 The following tables illustrate calculation of diluted EPS for the third quarter.

Third Quarter 20X1

Diluted EPS Computation

Income available to common stockholders		$ 495,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	$ 5,000	
Effect of assumed conversions		5,000
Income available to common stockholders + assumed conversions		500,000
Loss on discontinued operations		(2,000,000)
Net loss available to common stockholders + assumed conversions		$ (1,500,000)
Weighted-average shares		4,266,666
Plus: Incremental shares from assumed conversions		
Warrants	51,643[(a)]	
Convertible preferred stock	100,000	
Dilutive potential common shares		151,643
Adjusted weighted-average shares		4,418,309
Diluted EPS		
Income from continuing operations	$ 0.11	
Loss on discontinued operations	$ (0.45)	
Net loss	$ (0.34)	

The equation for computing diluted EPS is:

$$\frac{\text{Income available to common stockholders + Effect of assumed conversions}}{\text{Weighted-average shares + Dilutive potential common shares}}$$

(a) [($71 – $60) ÷ $71] × 500,000 = 77,465 shares; 77,465 × ⅔ = 51,643 shares

Note that the incremental shares from assumed conversions are included in computing the diluted per-share amounts for the discontinued operation and net loss even though they are antidilutive. This is because the control number (income from continuing operations, adjusted for preferred dividends) was income, not a loss. (See paragraphs 260-10-45-18 through 45-19.)

55-46 The following tables illustrate calculation of basic and diluted EPS for the fourth quarter.

Fourth Quarter 20X1

Basic and Diluted EPS Computation	
Net loss	$ (500,000)
Plus: Preferred stock dividends	(5,000)
Net loss available to common stockholders	$ (505,000)

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
October 1–December 31	4,600,000	3/3	4,600,000
Weighted-average shares			4,600,000

Basic and Diluted EPS	
Net loss	$ (0.11)

The equation for computing basic (and diluted) EPS is:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

Note that the incremental shares from assumed conversions are not included in computing the diluted per-share amounts for net loss because the control number (net loss adjusted for preferred dividends) was a loss, not income. (See paragraphs 260-10-45-18 through 45-19.)

55-47 The following tables illustrate calculation of basic EPS for the full year 20X1.

Full Year 20X1

Basic EPS Computation	
Income from continuing operations	$ 7,500,000
Less: Preferred stock dividends	(45,000)
Income available to common stockholders	7,455,000
Loss on discontinued operations	(2,000,000)
Net income available to common stockholders	$ 5,455,000

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
January 1–February 28	3,300,000	2/12	550,000
Issuance of common stock on March 1	100,000		
March 1–March 31	3,400,000	1/12	283,333

Conversion of 4% debenture on April 1	200,000		
April 1–May 31	3,600,000	2/12	600,000
Conversion of preferred stock on June 1	500,000		
June 1–August 31	4,100,000	3/12	1,025,000
Exercise of warrants on September 1	500,000		
September 1–December 31	4,600,000	4/12	1,533,333
Weighted-average shares			3,991,666

Basic EPS

Income from continuing operations	$ 1.87
Loss on discontinued operations	$ (0.50)
Net income	$ 1.37

The equation for computing basic EPS is:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

55-48 The following tables illustrate calculation of diluted EPS for the full year 20X1.

Full Year 20X1

Diluted EPS Computation

Income available to common stockholders		$ 7,455,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	$ 45,000	
Interest on 4% convertible debentures	60,000	
Effect of assumed conversions		105,000
Income available to common stockholders + assumed conversions		7,560,000
Loss on discontinued operations		(2,000,000)
Net income available to common stockholders + assumed conversions		$ 5,560,000
Weighted-average shares		3,991,666
Plus: Incremental shares from assumed conversions		
Warrants	30,768[(a)]	
Convertible preferred stock	308,333[(b)]	
4% convertible debentures	50,000[(c)]	
Dilutive potential common shares		389,101
Adjusted weighted-average shares		4,380,767

Diluted EPS

Income from continuing operations	$	1.73
Loss on discontinued operations	$	(0.46)
Net income	$	1.27

The equation for computing diluted EPS is:

$$\frac{\text{Income available to common stockholders + Effect of assumed conversions}}{\text{Weighted-average shares + Dilutive potential common shares}}$$

(a) (71,429 shares × $^{3}/_{12}$) + (51,643 shares × $^{3}/_{12}$)
(b) (600,000 shares × $^{5}/_{12}$) + (100,000 shares × $^{7}/_{12}$)
(c) 200,000 shares × $^{3}/_{12}$

55-49 The following table illustrates how Entity A might present its EPS data on its income statement. Note that the per-share amount for the discontinued operation is not required to be shown on the face of the income statement.

	For the Year Ended 20X1
Earnings per common share	
Income from continuing operations	$ 1.87
Loss on discontinued operations	(0.50)
Net income	$ 1.37
Earnings per common share—assuming dilution	
Income from continuing operations	$ 1.73
Loss on discontinued operations	(0.46)
Net income	$ 1.27

55-50 The following table includes the quarterly and annual EPS data for Entity A. The purpose of this table is to illustrate that the sum of the four quarters' EPS data will not necessarily equal the annual EPS data. This Subtopic does not require disclosure of this information.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Basic EPS					
Income (loss) from continuing operations	$ 0.89	$ 1.19	$ 0.12	$ (0.11)	$ 1.87
Loss on discontinued operations	-	-	(0.47)	-	(0.50)
Net income (loss)	$ 0.89	$ 1.19	$ (0.35)	$ (0.11)	$ 1.37
Diluted EPS					
Income (loss) from continuing operations	$ 0.74	$ 1.05	$ 0.11	$ (0.11)	$ 1.73

Loss on discontinued operations	-	-	(0.45)	-	(0.46)
Net income (loss)	$ 0.74	$ 1.05	$ (0.34)	$ (0.11)	$ 1.27

Excerpt from ASC 260-10

• > Example 9: Participating Securities and the Two-Class Method

55-71 Participating securities should be included in the computation of basic earnings per share using the two-class method. The following Cases illustrate the guidance in paragraphs 260-10-45-59A through 45-70 for the application of the two-class method of computing basic earnings per share when:

a. An entity has participating convertible preferred stock (Case A).
b. An entity has participating convertible bonds (Case B).
c. An entity has participating warrants (Case C).
d. An entity has participating share-based payment awards (Case D).

55-72 The application of the two-class method in each of Cases A, B, and C presents an EPS calculation for both the common stock and the participating security. This presentation is for illustrative purposes only. The presentation of EPS is only required for each class of common stock (as clarified by this Example). However, the presentation of basic and diluted EPS for a participating security other than common stock is not precluded. Cases A, B, and C share both of the following assumptions:

a. 10,000 shares of Class A common stock
b. Reported net income of $65,000 for 20X1.

• • > Case A: Participating Convertible Preferred Stock

55-73 Assume that Entity A had 5,000 shares of preferred stock outstanding during 20X1. Each share of preferred stock is convertible into two shares of Class A common stock. The preferred stock is entitled to a noncumulative annual dividend of $5 per share. After Class A has been paid a dividend of $2 per share, the preferred stock then participates in any additional dividends on a 40:60 per share ratio with Class A. For 20X1, the Class A shareholders have been paid $26,000 (or $2.60 per share), and the preferred shareholders have been paid $27,000 (or $5.40 per share). Basic EPS under the two-class method for 20X1 would be computed as follows.

Net income		$ 65,000
Less dividends paid:		
Class A common	$ 26,000	
Preferred stock	27,000	53,000
Undistributed 20X1 earnings		$ 12,000

Allocation of undistributed earnings:

To preferred:

$0.4(5,000) \div [0.4(5,000) + 0.6(10,000)] \times \$12,000 = \$3,000$

$\$3,000 \div 5,000 \text{ shares} = \$0.60 \text{ per share}$

To common:

0.6(10,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $9,000
$9,000 ÷ 10,000 shares = $0.90 per share

Basic earnings per share amounts:

	Preferred	Class A
Distributed earnings	$ 5.40	$ 2.60
Undistributed earnings	0.60	0.90
Total	$ 6.00	$ 3.50

• • > Case B: Participating Convertible Debt Instrument

55-74 Assume that on January 1, 20X1, Entity A issues 1,000 30-year convertible bonds with an aggregate par value of $1,000,000. Each bond is convertible into 8 shares of Class A common stock and carries a coupon rate of 3 percent. After Class A has been paid a dividend of $2 per share, the bondholders then participate in any additional dividends on a 40:60 per share ratio with Class A shareholders. The bondholders receive common stock dividends based on the number of shares of common stock that the bonds are convertible into. The bondholders do not have any voting rights prior to conversion into common stock. For 20X1, the Class A shareholders have been paid $20,000 (or $2.00 per share). Basic EPS under the two-class method for 20X1 would be computed as follows.

Net income		$ 65,000
Less dividends paid:		
Class A common	$ 20,000	20,000
Undistributed 20X1 earnings		$ 45,000

Allocation of undistributed earnings:

To convertible bonds:

0.4(8,000) ÷ [0.4(8,000) + 0.6(10,000)] × $45,000 = $15,652
$15,652 ÷ 8,000 shares = $1.96 per share

To common:

0.6(10,000) ÷ [0.4(8,000) + 0.6(10,000)] × $45,000 = $29,348
$29,348 ÷ 10,000 shares = $2.93 per share

Basic earnings per share amounts:

	Convertible Bonds	Class A
Distributed earnings	$ -	$ 2.00
Undistributed earnings	1.96	2.93
Total	$ 1.96	$ 4.93

• • > Case C: Participating Warrants

55-75 Assume that Entity A had warrants to purchase 5,000 shares of common stock outstanding during 20X1 Each warrant entitles the holder to purchase 1 share of common stock at $10 (fair value at date of grant) per share. In addition, the warrant holders receive dividends on the underlying common stock to the extent they are declared. For 20X1, common shareholders have been paid $26,000 (or $2.60 per share), and the warrant holders have been paid $13,000 (or, also, $2.60 per share). Basic EPS under the two-class method for 20X1 would be computed as follows:

Net income		$ 65,000
Less dividends paid:		
Common stock	$ 26,000	
Warrants	13,000	39,000
Undistributed 20X1 earnings		$ 26,000

Allocation of undistributed

To warrants:

0.5(5,000) ÷ [0.5(5,000) + 0.5(10,000)] × $26,000 = $8,667

$8,667 ÷ 5,000 shares = $1.73 per share

To common:

0.5(10,000) ÷ [0.5(5,000) + 0.5(10,000)] × $26,000 = $17,333

$17,333 ÷ 10,000 shares = $1.73 per share

Or, to simplify, since the common shareholders and the warrant holders share in dividends on a one-to-one basis, undistributed earnings could also be calculated as follows.

$26,000 ÷ 15,000 shares = $1.73 per common share and warrant.

Basic earnings per share amounts:

	Common	**Warrants**
Distributed earnings	$2.60	$2.60
Undistributed earnings	1.73	1.73
Total	$4.33	$4.33

• • > Case D: Participating Share-Based Payment Awards

55-76A Assume that Entity A had 25,000 shares of common stock and 5,000 unvested share-based payment awards outstanding during 20X8 and reported net income of $100,000. The share-based payment awards participate in any dividends on a 1:1 per-share ratio with common stock, and the dividends are nonforfeitable by the holder of the share-based payment awards. Entity A's accounting policy is to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-3.

55-76B As of the beginning of 20X8, Entity A estimated that the requisite service will not be provided for 200 of the 5,000 share-based payment awards outstanding. At the end of 20X8, Entity A adjusts its estimate to reflect an increased expected forfeiture rate and now expects that the requisite service will not be provided for 300 awards. It recognizes the cumulative effect of this change in compensation cost in the current period.

55-76C Entity A paid a $1.50 per-share dividend at the end of 20X8. Net income includes an expense of $450 related to dividends paid to the awards for which the requisite service is not expected to be rendered in accordance with paragraph 718-10-55-45. Basic EPS under the two-class method for 20X8 would be computed as follows:

Net income		$ 100,000
Less dividends paid:		
Common stock	$ 37,500	
Unvested share-based payment awards	$ 7,050[(a)]	
		$ 44,550
Undistributed earnings		$ 55,450

(a) Reflects the dividends paid to unvested share-based payment awards ($7,500 = 5,000 unvested share-based payment awards × $1.50 dividend per share) less the dividends paid to awards for which the requisite service is not expected to be rendered ($450 = 300 share-based payment awards for which the requisite service is not expected to be rendered × $1.50 dividend per share). Dividends paid on awards for which the requisite service is not expected to be rendered are already recognized in net income as additional compensation cost.

Allocation of undistributed earnings:

To unvested share-based payment awards:

5,000 ÷ (5,000 + 25,000) × $55,450 = $9,242

$9,242 ÷ 5,000 total unvested share-based payment awards = $1.85 per share

To common:

25,000 ÷ (5,000 + 25,000) × $55,450 = $46,208

$46,208 ÷ 25,000 shares of common stock = $1.85 per share

Or, to simplify, because the common shareholders and the share-based payment award holders share in dividends on a 1:1 basis, undistributed earnings could also be calculated as follows:

$55,450 ÷ 30,000 shares[(b)] = $1.85 per common share and share-based payment award

(b) 25,000 shares of common stock + 5,000 total unvested share-based payment awards

Basic earnings per share amounts:

	Unvested Share-Based Payment Awards	Common Stock
Distributed earnings	$ 1.41[(c)]	$ 1.50
Undistributed earnings	1.85	1.85
	$ 3.26	$ 3.35

(c) $7,050 of distributed earnings allocated to the unvested share-based payment awards divided by 5,000 total unvested share-based payment awards. Although all unvested share-based payment awards received a payment of $1.50 per share, totaling $7,500, only dividends to awards for which the requisite service is expected to be rendered are considered distributed earnings as that term is used in paragraph 260-10-45-60B(a). Dividends paid on awards for which the requisite service is not expected to be rendered are recognized in net income as additional compensation cost.

55-76D Note that in this illustrative example, application of the two-class method presents an EPS calculation for both the common stock and the participating security, that is, the unvested share-based payment awards. This presentation is for illustrative purposes only. The presentation of EPS is only required for each class of common stock. However, the presentation of basic and diluted EPS for a participating security other than common stock is not precluded. The disclosure in the notes to financial statements of actual distributions to unvested share-based payment awards, rather than the amount presented as distributed earnings, also is not precluded to reconcile earnings per common share and per unvested share-based payment awards. For example, Entity A in the example above may disclose that actual distributions to unvested share-based payment awards were $7,500 and that $450 of those distributions was included in net income as compensation cost related to awards for which the requisite service is not expected to be rendered. Disclosure on a per-share basis also is not precluded.

Excerpt from ASC 260-10

See Appendix A for guidance that applies before the adoption of ASU 2020-06.

• > Example 11: Computation of Basic and Diluted EPS for Two Examples of Contingently Convertible Instruments

55-78 The following Cases illustrate the guidance in paragraphs 260-10-45-43 through 45-46 related to diluted EPS computations for three examples of contingently convertible instruments:

a. Contingently convertible debt with a market price trigger (Case A)
b. Contingently convertible debt with a market price trigger, issuer must settle the principal amount of the debt in cash, but may settle any conversion premium in either cash or stock (Case B).
c. Convertible debt for which the principal and conversion premium can be settled in any combination of shares or cash (Case C).

55-79 Cases A, B and C share all of the following assumptions:

a. Principal amount of the convertible debt: $1,000
b. Conversion ratio: 20
c. Conversion price per share of common stock: $50 Conversion price = (Convertible bond's principal amount) ÷ (Conversion ratio) = $1,000 ÷ 20 = $50.
d. Share price of common stock at issuance: $40
e. Market price trigger: average share price for the year must exceed $65 (130% of conversion price)
f. Interest rate: 4%
g. Effective tax rate: 35%
h. Shares of common stock outstanding: 2,000.

• • > Case A: Contingently Convertible Debt with a Market Price Trigger

55-81 The holder of the debt may convert the debt into shares of common stock when the share price exceeds the market price trigger; otherwise, the holder is only entitled to the par value of the debt.

55-82 The contingently convertible debt is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X, is $10,000, and the average share price for the year is $55. The issuer of the contingently convertible debt should apply the guidance in paragraphs 260-10-45-43 through 45-44, which requires the issuer to include the dilutive effect of the convertible debt in diluted EPS even though the market price trigger of $65 has not been met. In this Case, basic EPS is $5.00. (Basic EPS = [Income available to common shareholders (IACS)] ÷ [Shares outstanding (SO)] = $10,000 ÷ 2,000 shares = $5.00 per share) and applying the if-converted method to the debt instrument dilutes EPS to $4.96 (Diluted EPS computed using the if-converted method = [IACS + Interest (1-tax rate)] ÷ (SO + Potential common shares) = ($10,000 + $26) ÷ (2,000 + 20) shares = $4.96 per share.)

• • > Case B: Contingently Convertible Debt with a Market Price Trigger, Issuer Must Settle Principal in Cash, but May Settle Conversion Premium in either Cash or Stock

55-84 The issuer of the contingently convertible debt must settle the principal amount of the debt in cash upon conversion and it may settle any conversion premium in either cash or stock. The holder of the instrument is only entitled to the conversion premium if the share price exceeds the market price trigger. The contingently convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X is $9,980, and the average share price for the year is $64.

55-84A The if-converted method should not be used to determine the earnings-per-share implications of convertible debt with the characteristics described in this Case. There would be no adjustment to the numerator in the diluted earnings-per-share computation for the cash-settled portion of the instrument (the principal amount of the debt) because that portion will always be settled in cash (see paragraph 260-10-45-40). The conversion premium should be included in diluted earnings per share based on the provisions of paragraphs 260-10-45-45 through 45-46 and 260-10-55-32 through 55-36A. The convertible debt instrument in this Case is subject to other applicable guidance in Subtopic 260-10 as well, including the antidilution provisions of that Subtopic.

55-84B In this example, basic EPS is $4.99, and diluted earnings per share is $4.98. Basic EPS = IACS ÷ SO = $9,980 ÷ 2,000 shares = $4.99 per share. Diluted EPS would be calculated using the if-converted method by determining the number of shares needed to settle the conversion premium and adding that amount to shares outstanding to calculate the diluted EPS denominator. The average market price is used to determine the dilution in accordance with paragraph 260-10-45-21A. The effect would be dilutive in this case because the average market price of the shares exceeds the conversion price. However, if the average market price of the shares was less than the conversion price, then the conversion premium would be zero and there would be no dilutive effect._Diluted EPS = IACS ÷ (SO + Potential common shares) = ($9,980) ÷ (2,000 + 4.38) shares = $4.98 per share. Potential common shares = (Conversion spread value) ÷ (Average share price) = $14 × 20 shares ÷ $64 = 4.38 shares.

• • > Case C: Convertible Debt That the Principal and Conversion Premium Can Be Settled in Any Combination of Shares or Cash

55-84C The issuer of the convertible debt can settle the principal and the conversion premium in any combination of cash or shares (the issuer has the option). Consistent with the facts in Case B, the convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X, is $9,980, and the average share price for the year is $64.

55-84D The if-converted method should be used to determine the earnings-per-share implications of convertible debt. The effect of settling the principal and conversion premium in shares is included for purposes of calculating diluted earnings per share in accordance with the guidance in paragraph 260-10-45-45.

55-84E In this case, basic EPS is $4.99 (the same calculation in paragraph 260-10-55-84B), and diluted earnings per share is $4.95. Diluted EPS is calculated using the if-converted method = [IACS + Interest (1-tax rate)] ÷ (SO + Potential common shares) = (9,980 + 26) ÷ (2,000 + 20). See paragraph 260-10-55-82 for interest expense amount.

A. EPS pre-ASU 2020-06 and/or ASU 2021-04

Detailed contents

Navigating this appendix

Moved from chapter 3, Basic EPS – The foundations

Examples

Questions

Navigating this appendix

This handbook has been updated for ASU 2020-06 and ASU 2021-04. For entities who have yet to adopt ASU 2020-06 and/or ASU 2021-04, this Appendix includes the guidance that is superseded once the ASUs are adopted.

The sections in this Appendix retain the guidance that existed in the previous edition of this Handbook and are intended to be used in place of the corresponding sections in the main handbook. They retain the same numbering convention as originally presented except for:

— the addition of an A after the section number to identify it is as the Appendix; and
— newly added Question 6.9A.94 that is identified with .

ASU 2020-06 and ASU 2021-04

In August 2020, the FASB issued Accounting Standards Update (ASU) 2020-06, Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity. Within this ASU, the FASB chose to simplify EPS calculations for convertible instruments, and made the primary changes detailed in the About this publication section.

ASU 2020-06 is effective for:

— Public business entities that meet the definition of an SEC) filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, for annual and interim periods in fiscal years beginning after December 15, 2021.

— All other entities, for annual and interim periods in fiscal years beginning after December 15, 2023.

Early adoption is permitted, but no earlier than annual and interim periods in fiscal years beginning after December 15, 2020.

In May 2021, the FASB Issued ASU 2021-04, Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815- 40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options.

The ASU provides guidance on an issuer's accounting for modifications of written call options that remain equity-classified after modification. Modifications that do not represent a cost of financing or compensation in a reciprocal transaction are treated as a deemed dividend (i.e. an adjustment to retained earnings). This results in an adjustment to the numerator when calculating basic EPS.

ASU 2021-04 is effective for all entities for interim and annual periods in fiscal years beginning after December 15, 2021.

Early adoption is permitted, including adoption in an interim period, as of the beginning of that fiscal year.

3.3A Step 1: Determine the numerator

3.3A.40 Original issue discount on increasing-rate preferred shares and beneficial conversion features

Increasing-rate preferred shares are a type of preferred share where the coupon rate is usually zero or a lower rate in the initial years and increases over time to a higher permanent rate. Because of their lower initial coupon rate, increasing-rate preferred shares generally are issued at a discount. The discount is based on the price for which the preferred shares would have sold had the permanent dividend rate been in effect at issuance. As a result, the discount represents a prepaid, unstated dividend cost.

Question 3.3A.40

How do increasing-rate preferred shares affect income available to common shares?

Interpretive response: SEC guidance requires the discount to be amortized through a charge to retained earnings and a corresponding increase in the carrying amount of the preferred shares using the effective interest rate inherent in the shares (rather than the nominal dividend schedule for the shares) to reflect a constant rate of return for the shares. [505-10-S99-7]

An entity should treat those periodic increases like a dividend on nonredeemable preferred shares for EPS calculations – i.e. as a reduction in income available to common shareholders. [505-10-S99-7]

Example 3.3A.30

Original issue discount on increasing-rate preferred shares

On January 1, Year 1, ABC Corp. issues 10,000 nonredeemable cumulative preferred shares with a par value of $100 each.

- Each share is entitled to a cumulative dividend of $7 each year, starting from Year 4, paid in arrears.
- At the time of issuance, the market yield on instruments with similar terms is 7% per annum.
- Each share is issued for $81.63, producing a discount of $18.37. This discount compensates for the below-market dividend yield in the first three years.
- Net income for Year 1 is $400,000.

ABC classifies the preferred shares as equity instruments and amortizes the original issue discount to retained earnings using the effective interest method.

Basic EPS numerator calculation – Year 1

The annual amortization of the original issue discount on ABC's increasing-rate preferred shares in the first three years is treated as a preferred dividend when determining the numerator.

	Year 1	Year 2	Year 3	Year 4 onward
Carrying amount of one preferred share at January 1	$81.63	$87.34	$93.46	$100.00
Imputed dividend at 7% (amortization of original issue discount), recognized directly in equity[1]	5.71	6.12	6.54	7.00
Dividend paid	–	–	–	(7.00)
Carrying amount of one preferred share at December 31	**$87.34**	**$93.46**	**$100.00**	**$100.00**

Note:

1. Year 4 onward reflects a cumulative dividend.

Assuming this is the only necessary adjustment, the numerator for basic EPS in Year 1 is determined as follows.

Step **Basic EPS**

1

Determine the numerator

The imputed dividend on the preferred shares in Year 1 is deducted from net income to determine the income available to common shareholders.

Net income	$400,000
Imputed dividend on preferred shares [10,000 × $5.71]	(57,100)
Income available to common shareholders	**$342,900**

Accordingly, the numerator is $342,900.

Question 3.3A.50

How do convertible preferred shares with a beneficial conversion feature affect income available to common shareholders?

Background: An entity may issue convertible preferred shares with an embedded conversion feature that is in-the-money at the commitment date (a beneficial conversion feature). Following Topic 470 (debt), an entity recognizes and measures a beneficial conversion feature by allocating a portion of the proceeds equal to the intrinsic value of that feature to equity. [470-20-30-5]

Interpretive response: For convertible preferred shares that are equity-classified, a recorded discount that results from allocating proceeds to the beneficial conversion feature is analogous to a dividend and is recognized as a return to the preferred shareholders. For convertible preferred shares that are liability-classified, a recorded discount that results from allocating proceeds to the beneficial conversion feature is analogous to additional interest expense and is recognized in the income statement. The period of accretion depends on whether the instrument is perpetual or puttable/redeemable.

— **Perpetual.** Accrete to the earliest conversion date. [470-20-35-7c]
— **Puttable/redeemable.** Accrete to the earliest put/redemption date. [470-20-35-7a]

For convertible preferred shares that are equity classified, the discount is accreted and deducted from income to arrive at income available to common shareholders in the EPS calculation.

However, for convertible preferred shares that are liability-classified, the unaccreted discount is charged to net income. Therefore, no adjustment to income available to common shareholders is necessary in basic EPS because the accretion is already deducted from income. However, an adjustment is made in the diluted EPS calculation to reverse this charge, because the instruments are considered converted from the beginning of the period (see section 4.4A.30).

3.3A.50 Differences on settlement of equity-classified preferred shares

Excerpt from ASC 260-10

• • > SEC Staff Announcement: The Effect on the Calculation of Earnings Per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock

S99-2 The following is the text of SEC Staff Announcement: The Effect on Calculation of Earnings Per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock.

Scope

This SEC staff announcement applies to redemptions and induced conversions of equity-classified preferred stock instruments. For purposes of this announcement:

1. Modifications and exchanges of preferred stock instruments that are accounted for as extinguishments, resulting in a new basis of accounting for the modified or exchanged preferred stock instrument, are considered redemptions.
2. A preferred stock instrument classified within temporary equity pursuant to the guidance in ASR 268 and paragraph 480-10-S99-3A is considered equity-classified, and redemptions and induced conversions of such securities would be subject to this guidance.
3. If an equity-classified security is subsequently required to be reclassified as a liability based on the provisions of other GAAP (for example, because

a preferred share becomes mandatorily redeemable pursuant to Subtopic 480-10), the reclassification is considered a redemption of equity by issuance of a debt instrument.

The accounting for conversions of preferred stock instruments into other equity-classified securities pursuant to conversion privileges provided in the terms of the instruments at issuance is not affected by this announcement.

The Effect on Income Available to Common Stockholders of a Redemption or Induced Conversion of Preferred Stock

If a registrant redeems its preferred stock, the SEC staff believes that the difference between (1) the fair value of the consideration transferred to the holders of the preferred stock and (2) the carrying amount of the preferred stock in the registrant's balance sheet (net of issuance costs) should be subtracted from (or added to) net income to arrive at income available to common stockholders in the calculation of earnings per share. The SEC staff believes that the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the preferred stock in the registrant's balance sheet represents a return to (from) the preferred stockholder that should be treated in a manner similar to the treatment of dividends paid on preferred stock. This calculation guidance applies to redemptions of convertible preferred stock regardless of whether the embedded conversion feature is "in-the-money" or "out-of-the-money" at the time of redemption. The fair value of the consideration transferred is reduced by the commitment date intrinsic value of the conversion option if the redemption includes the reacquisition of a previously recognized beneficial conversion feature in a convertible preferred stock instrument.

If convertible preferred stock is converted into other securities issued by the registrant pursuant to an inducement offer, the SEC staff believes that the excess of (1) the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over (2) the fair value of securities issuable pursuant to the original conversion terms should be subtracted from net income to arrive at income available to common stockholders in the calculation of earnings per share. Registrants should consider the guidance provided in Subtopic 470-20 to determine whether the conversion of preferred stock is pursuant to an inducement offer.

Equity-classified preferred shares may be repurchased, redeemed or converted. Any differences on settlement – e.g. an excess of the fair value of the consideration paid over the carrying amount of the preferred shares – represent a return to the holders of the preferred shares that is not recognized in earnings. Accordingly, the numerator is adjusted for any differences on the settlement of equity-classified preferred shares. The numerator is also adjusted for 'other similar effects' of equity-classified preferred shares.

The guidance that follows relates to both equity-classified preferred shares, as well as preferred shares classified as temporary equity under paragraph 480-10-S99-3A.

Redeeming preferred shares

Redeeming preferred shares also results in an adjustment to income available to common shareholders if the amounts paid to settle the shares differ from their carrying amount before redemption. An entity deducts all amounts paid on redemption of the shares over their carrying amount (regardless of redemption rights) to determine income available to common shareholders for EPS calculations.

The SEC staff believes this amount represents a return to the preferred shareholders; therefore, an entity should treat it in a manner similar to dividends paid (i.e. a deemed dividend) to the preferred shareholders in its EPS calculation. An entity adds any excess of the carrying amount of preferred shares over the fair value of the consideration transferred to preferred shareholders to net income to determine net income available to common shareholders (i.e. a deemed contribution). An entity may disclose those amounts separately or combined with dividends and accretion, including on a per share basis. Also, any accumulated but unpaid preferred dividends already deducted from income available to common shareholders are added to the carrying amount of the preferred shares in the calculation, to prevent double counting the dividend – assuming the value of the preferred dividend is reflected in the fair value of the consideration transferred. [260-10-S99-2]

We believe this SEC guidance should be applied by all entities that present EPS. The calculation of the deemed dividend differs depending on whether there is a beneficial conversion feature (see Examples 3.3A.40 and 3.3A.50).

Example 3.3A.40
Redeeming convertible preferred shares – no beneficial conversion feature

Year 1 issuance

On January 1, Year 1, ABC Corp. issues 1,000 convertible preferred shares for their par amount of $1,000 per share and issuance costs of $100,000 ($900,000 net proceeds).

- The preferred shares are redeemable by ABC (but not mandatorily redeemable) and there are no embedded put options that could allow the holder to require ABC to redeem the shares.
- Each share is immediately convertible into 100 common shares (i.e. $10 effective conversion price). The fair value of ABC's common shares is less than the effective conversion price on the commitment date, so there is no beneficial conversion feature.
- Neither the redemption option nor the conversion option is required to be separately accounted for as a derivative.

ABC records the following journal entry when the shares are issued.

	Debit	Credit
Cash	900,000	
Preferred shares – discount	100,000	
Preferred shares		1,000,000
To record issuance of preferred shares and related issuance costs.		

Year 2 redemption

In Year 2, ABC redeems all of the convertible preferred shares for $1,850 cash per share (total consideration of $1,850,000).

Net income for Year 2 is $5,000,000.

ABC records the redemption in the following journal entry.

	Debit	Credit
Preferred shares	1,000,000	
Retained earnings	950,000	
Preferred shares – discount		100,000
Cash		1,850,000
To record redemption of preferred shares.		

Basic EPS numerator calculation – Year 2

Assuming this is the only instrument with a necessary adjustment, the numerator for basic EPS in Year 2 is calculated as follows.

Step **Basic EPS**

1

Determine the numerator

The excess of the consideration paid to preferred shareholders over the preferred shares' carrying amount is deducted from net income to determine the income available to common shareholders.

Net income	$5,000,000
Excess of consideration paid to preferred shareholders over preferred shares carrying amount (net of issuance costs) [$1,850,000 – ($1,000,000 – $100,000)]	(950,000)
Income available to common shareholders	**$4,050,000**

Accordingly, the numerator is $4,050,000.

Question 3.3A.60

Does the SEC guidance on redemptions and induced conversions of preferred shares apply to other types of preferred share transactions?

Interpretive response: Yes. The SEC guidance specifically includes redemptions of preferred shares and induced conversions of preferred shares, although 260-10-S99-2 can also be applied to other preferred share transactions.

According to the SEC staff, the following situations are considered redemptions and the 260-10-S99-2 guidance applies. [260-10-S99-2]

— An equity-classified preferred share instrument is modified or exchanged, and there is a new basis of accounting for the instrument – e.g. the transaction is accounted for as an extinguishment.

— An equity-classified (including those that are temporary-equity) preferred share is reclassified as a liability – e.g. if it becomes mandatorily redeemable, such as when a condition for redemption is resolved.

When preferred shares are classified as a liability, the 260-10-S99-2 guidance is not applied when those preferred shares are modified, exchanged or converted. [260-10-S99-2]

However, when the guidance in paragraph 260-10-S99-2 does not apply, amounts may be recognized as deemed dividends under other accounting guidance, also resulting in an adjustment to income available to common shareholders. This may occur when:

— an equity-classified preferred share is modified or exchanged and modification accounting is applied, and the incremental value obtained therefrom results in incremental value to the preferred shareholder resulting in a deemed dividend; or

— an equity-classified preferred share is converted according to the stated conversion privileges (i.e. is not an induced conversion) and unamortized discounts are reflected as a deemed dividend upon conversion.

Question 3.3A.90 discusses instruments other than preferred shares and the applicability of 260-10-S99-2 to related transactions.

Question 3.3A.70

How does redeeming convertible preferred shares with a beneficial conversion feature affect income available to common shareholders?

Interpretive response: If an entity redeems convertible preferred shares with a beneficial conversion feature, the following should be subtracted from income to arrive at net income available to common shareholders.

Fair value of the consideration transferred to the holders of the convertible preferred security − (**Carrying amount of the convertible preferred shares on the issuer's balance sheet[1]** + **Amount previously recognized for the beneficial conversion option**) = **Adjustment to income available to common shareholders**

Note:

1. Accumulated/declared but unpaid dividends are added to carrying amount unless already deducted from income available to common shareholders.

On redemption, the issuer allocates an amount to reacquire the embedded conversion option equal to the intrinsic value previously recognized for the beneficial conversion option. The remaining reacquisition price is allocated to reacquiring the convertible preferred shares. Any difference between that portion of the reacquisition price and the carrying amount of the convertible preferred shares reduces (or increases) income available to common shareholders in the EPS calculation. [260-10-S99-2]

Example 3.3A.50

Redeeming convertible preferred shares – with beneficial conversion feature

Year 1 issuance

On January 1, Year 1, ABC Corp. issues 1,000 convertible preferred shares at the face amount of $1,000 per share ($1,000,000 proceeds). Issuance costs are immaterial.

— The preferred shares are redeemable by ABC.

— Each share is immediately convertible into 100 common shares (i.e. $10 effective conversion price). The fair value of ABC's common shares is $12 per share on the commitment date. Therefore, the convertible preferred shares contain a $200,000 beneficial conversion feature: (1,000 preferred shares × 100 common shares) × ($12.00 – $10.00).

— Neither the redemption option nor conversion option are required to be separately accounted for as a derivative.

ABC records the following journal entries when the shares are issued.

	Debit	*Credit*
Cash	1,000,000	
Preferred shares discount	200,000	
Preferred shares		1,000,000
APIC – beneficial conversion feature		200,000
To record issuance of preferred shares with beneficial conversion feature.		

	Debit	Credit
Retained earnings	200,000	
Preferred shares discount		200,000
To accrete beneficial conversion feature to earliest conversion date.[1]		

Note:

1. The earliest conversion date is immediately because the preferred shares are immediately convertible.

Year 2 redemption

In Year 2, ABC redeems all of the convertible preferred shares for $1,850 cash per share (total consideration of $1,850,000).

There are no unpaid dividends outstanding.

ABC records the redemption in the following journal entry.

	Debit	Credit
Preferred shares	1,000,000	
APIC – beneficial conversion feature	200,000	
Retained earnings	650,000	
Cash		1,850,000
To record preferred share redemption.		

Net income in Year 2 is $5,000,000.

Basic EPS numerator calculation – Year 2

To determine the basic EPS numerator, ABC calculates the adjustment to income available to common shareholders as follows.

Fair value of the consideration transferred to the holders of the convertible preferred security
$1,850,000

−

(

Carrying amount of the convertible preferred shares on the issuer's balance sheet[1]
$1,000,000

+

Amount previously recognized for the beneficial conversion option
$200,000

)

=

Adjustment to income available to common shareholders
$650,000

Note:

1 Accumulated/declared but unpaid dividends are added to carrying amount unless already deducted from income available to common shareholders.

Assuming the convertible preferred shares are the only instruments with a necessary adjustment, the numerator of basic EPS in Year 2 is calculated as follows.

Step	Basic EPS
1	**Determine the numerator** The imputed dividend on the convertible preferred shares is deducted from net income to determine the income available to common shareholders.

Net income	$5,000,000
Imputed dividend on preferred shares [total of $850,000 less $200,000 recorded as dividend in Year 1]	(650,000)
Income available to common shareholders	**$4,350,000**

Accordingly, the numerator is $4,350,000.

Inducement for early conversion of preferred shares

An example of an 'other similar effect' to differences on the settlement of equity-classified preferred shares is an inducement for early conversion of equity-classified convertible preferred shares, either by favorably amending the original conversion terms or by paying additional consideration to the preferred shareholders. Similar to differences on settlement, such an inducement is not recognized in earnings but nevertheless represents a return to preferred shareholders for which the numerator is adjusted. [260-10-S99-2]

Question 3.3A.80

If the fair value of common shares paid in an early conversion of preferred shares exceeds the fair value of common shares issuable under the original conversion terms, how does the excess affect EPS?

Interpretive response: The SEC believes that if the fair value of the common shares or other consideration paid exceeds the fair value of the common shares issuable under the original conversion terms (e.g. in an inducement offer), this excess is a return to preferred shareholders and is deducted from net income (or loss) in arriving at the numerator for basic EPS. [260-10-S99-2]

Fair value of all securities and other consideration transferred in the transaction by the registrant to the convertible preferred shareholders	−	Fair value of securities issuable according to the original conversion terms	=	**Adjustment to income available to common shareholders**

This guidance applies only to induced conversions, and not to conversions effected pursuant to the original terms of the instrument (see Question 3.3A.110). Subtopic 470-20 (debt with conversion and other options) contains guidance on determining if a conversion is pursuant to an inducement offer. [260-10-S99-2]

Observation
Redemption vs inducement

A redemption may result in a deemed dividend or a deemed contribution, depending on whether the adjustment to an instrument's carrying amount upon redemption is an increase or decrease.

In contrast, an inducement will always result in a deemed dividend, even if the conversion, after the offer, is out-of-the-money. This is because in an inducement, SEC guidance requires comparing the *fair values* of the instruments (1) that (would have been received under the original agreement and (2) under the inducement offer – and the fair value for the inducement will always have a value that is greater. [260-10-S99-2]

Question 3.3A.85
At what point is the EPS effect of an inducement offer recognized?

Interpretive response: We believe an inducement is reflected in EPS when it is accepted by the holder, which is the earlier of when the holder of the instrument agrees to the offer, or converts. An inducement offer being made, in and of itself, does not trigger EPS implications.

Example 3.3A.60
Inducement for early conversion

Year 1 issuance

On January 1, Year 1, ABC Corp. issues convertible preferred shares with a par value of $1,000,000.

The preferred shares are:

- entitled to a dividend of $10 per share each year (noncumulative); and
- convertible at the holders' option into 500,000 common shares.

ABC classifies the preferred shares as equity instruments.

Year 2 conversion

During Year 2, in light of changes in market yields, ABC wishes to induce early conversion of the preferred shares. To achieve this, ABC agrees with the preferred shareholders to modify the conversion terms such that the preferred shares are convertible into 600,000 common shares – i.e. 100,000 additional common shares will be issued on a full conversion.

- All of the preferred shares are converted into common shares on June 30, Year 2, when the market price per common share is $2.50.
- No dividends are declared for Year 2.
- Net income for Year 2 is $1,000,000.

Basic EPS numerator calculation – Year 2

Step	Basic EPS
1	**Determine the numerator** The excess of the fair value of the consideration paid to preferred shareholders over the fair value of the common shares issuable under the original conversion terms is deducted from net income to determine the income available to common shareholders.

Net income	$1,000,000
Excess of the fair value of the consideration paid to preferred shareholders over the fair value of the common shares issuable under the original conversion terms [100,000 × $2.50]	(250,000)
Income available to common shareholders	**$750,000**

Accordingly, the numerator is $750,000.

Question 3.3A.90

Does the guidance on inducement for the early conversion of shares apply to instruments other than preferred shares?

Background: To raise capital in a prior period, ABC Corp. sold warrants to purchase its common shares to outside nonemployee investors for cash. The investors have no other relationship with ABC. To induce exercise of the outstanding warrants, ABC reduces the exercise price of the warrants for a 60-day period.

Interpretive response: No. We believe the SEC guidance on inducements for the early conversion of preferred shares in paragraph 260-10-S99-2 applies only to classes of equity securities other than common shares.

In the background facts, because we do not believe that warrants to purchase common shares are considered a separate class of equity securities apart from the underlying common shares, the reduction in the exercise price of the warrants is not subject to this SEC guidance.

We believe the reduction in exercise price of the warrants is like a cost of raising additional capital. Therefore, it will:

— result in a reduction in equity on exercise of the warrant (by receipt of a lower exercise price);
— have no effect on the numerator of the EPS calculation; and
— increase the dilutive effect of the warrant in the treasury stock method calculation (see chapter 4).

However, if the instruments are participating securities (see section 5.2), we believe an entity should analogize to the guidance on inducements of preferred securities and subtract the difference in fair value from income available to common shareholders. [260-10-S99-2]

Further, if the instruments are held by employees, the reduction in exercise price is generally considered compensation expense. [718-20-35-5]

Exchange or modification of preferred shares

Question 3.3A.100

How does the exchange of preferred shares for other preferred shares affect EPS?

Interpretive response: The SEC staff believes that when a registrant exchanges a preferred share instrument for another preferred share instrument (e.g. the terms change), the registrant must first determine whether that exchange is an extinguishment or a modification. [2014 AICPA Conf]

If the exchange is considered an extinguishment, the registrant treats the extinguishment for EPS purposes as if it had redeemed the original preferred share. See Redeeming preferred shares earlier in this section. [260-10-S99-2]

If the exchange is considered a modification, the registrant may be required to record an expense (e.g. compensation expense) or an EPS effect (i.e. deemed dividend) depending on the circumstances. Also, we believe any costs paid to investors in connection with the modification that were recorded in retained earnings are also treated as a deemed dividend when calculating EPS. [2014 AICPA Conf]

We believe this guidance should be applied by all entities. See also Question 3.3A.60.

Question 3.3A.105

Does a modification or exchange of preferred shares for little or no consideration affect EPS?

Background: Some modifications or exchanges of preferred shares involve little to no incremental transfer of value to the common shareholders. This occurs most commonly when existing preferred shares are modified or exchanged at the same time that a new series of preferred shares is issued. The modification might encompass concessions or accepting a declined value by the existing preferred shareholders to attract new investors.

Interpretive response: A modification or exchange of preferred shares for little or no consideration requires careful evaluation of the facts and circumstances of the preferred share transaction, including determining the fair value of the common shares before and after the transaction. Sometimes there is no value transferred to or from the common shareholders as part of the modification or exchange, and, therefore, no accounting entry is required for the modified or exchanged preferred stock.

When an entity's existing preferred shares have been modified or exchanged, we believe the entity should:

1. perform the evaluation of whether an incremental transfer of value has occurred to or from the common shareholders as a result of the preferred stock modification or exchange; then
2. consider whether it constitutes a modification or extinguishment as discussed in Questions 3.3A.60 and 3.3A.100.

If there is no incremental transfer of value in Step 1, there is no EPS effect, and no further analysis is needed.

Conversion of convertible preferred shares to other securities

Question 3.3A.110

How does an SEC registrant account for the exchange of convertible preferred shares for other securities?

Interpretive response: If a registrant converts convertible preferred shares to other securities issued by the registrant according to the preferred shares' original conversion terms (i.e. not an inducement), there is no incremental transfer of value to the preferred shareholders, and therefore no EPS numerator effect. [260-10-S99-2]

See Question 3.3A.80 for conversions that are not according to the preferred shares' original conversion terms (i.e. induced conversions).

3.3A.60 Down-round features in freestanding equity-classified financial instruments

Excerpt from ASC 260-10

• > Freestanding Equity-Classified Financial Instrument with a Down Round Feature

45-12B For a freestanding equity-classified **financial instrument** with a **down round feature**, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

45-12B For a freestanding equity-classified financial instrument and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) with a **down round feature**, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

A down-round feature is a feature in a convertible instrument or freestanding equity warrant that reduces the conversion price ('strike price') of an instrument in the case of a future triggering event.

For example, an issuing entity has outstanding Instrument A, a freestanding equity warrant with a down-round feature. Subsequently the entity issues Instrument B, a freestanding equity warrant with a strike price that is lower than Instrument A's strike price, which causes the down-round feature in Instrument A to be triggered. Instrument A's strike price would be reduced based on a formula in the terms of Instrument A.

Upon its trigger, economic value related to the down-round feature is transferred to the holders of Instrument A. An entity recognizes the value related to the down-round feature as an increase in additional paid-in capital and a decrease in retained earnings (i.e. as a deemed dividend). This transfer of value reduces income available to common shareholders in the period it is triggered. [260-10-45-12B]

Instruments with down-round features are further discussed in section 6.18.

4.2A Overview

Excerpt from ASC 260-10

> Diluted EPS

10-2 The objective of diluted EPS is consistent with that of basic EPS—to measure the performance of an entity over the reporting period—while giving effect to all dilutive potential common shares that were outstanding during the period.

• > Computation of Diluted EPS

45-16 The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In addition, in computing the dilutive effect of convertible securities, the numerator is adjusted to add back any convertible preferred dividends and the after-tax amount of interest recognized in the period associated with any convertible debt. The numerator also is adjusted for any other changes in income or loss that would result from the assumed conversion of those potential common shares, such as profit-sharing expenses. Similar adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods. See Example 1 (paragraph 260-10-55-38) for an illustration of this guidance.

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

45-16 The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In ~~addition, in~~ computing the dilutive effect of convertible securities, the numerator is adjusted in accordance with the guidance in paragraph 260-10-45-40. ~~to add back any convertible preferred dividends and the after-tax amount of interest recognized in the period associated with any convertible debt. The numerator also is adjusted for any other changes in income or loss that would result from the assumed conversion of those potential common shares, such as profit-sharing expenses. Similar adjustments~~ Adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods. See Example 1 (paragraph 260-10-55-38) for an illustration of this guidance.

Entities often issue financial instruments or enter into other contracts that **may** entitle their holders to common shares in the future. For example, an entity may issue a bond that is convertible into its common shares. These financial instruments or other contracts are referred to as 'potential common stock' or 'potential common shares' in Topic 260 (see chapter 2).

The use of the word 'may' is important. This word is used because the financial instruments and contracts referred to above include arrangements that:

— result in common shares being issued only if specified conditions are met (see section 6.10); and
— are not always settled but which 'may' be settled in common shares (see Question 4.3.30 and section 6.13A).

Effect of potential common shares on basic EPS

Potential common shares do not affect basic EPS until they are exercised or otherwise result in the issuance of common shares or a contingency is met. When this occurs, the weighted-average number of common shares (the denominator) increases. The income (loss) available to common shareholders (the numerator) may also be affected – e.g. when interest on a convertible bond no longer needs to be paid. Depending on the circumstances, the exercise or conversion of potential common shares may result in a decrease (dilution) or an increase (antidilution) in basic EPS (see chapter 3).

Effect of potential common shares on diluted EPS

Basic EPS does not consider the effect of a possible dilution to income available to common shareholders as a result of potential common shares outstanding during a reporting period. 'Diluted' EPS aims to fill this gap, by providing an additional historical performance measure that reflects the potential dilution to the entitlement of existing common shareholders that could occur if all of the dilutive potential common shares outstanding during a reporting period had become outstanding common shares during the period.

To calculate diluted EPS, an entity adjusts both the numerator (if necessary) and the denominator used in the basic EPS calculation for the effects of all dilutive potential common shares.

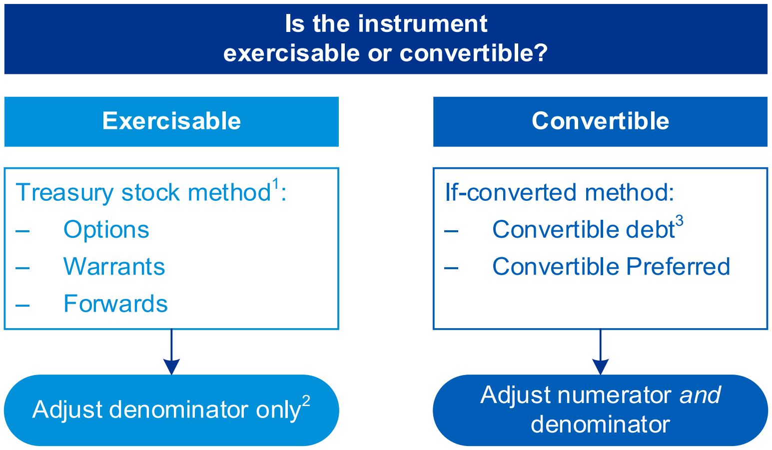
Numerator in basic EPS + adjustments for dilutive potential common shares	÷	Weighted-average number of outstanding common shares during the reporting period + adjustments for dilutive potential common shares	=	Diluted EPS

- **The numerator is adjusted** to add back dividends or interest on convertible securities that would not have occurred had the potential common shares been common shares for the entire reporting period (e.g. interest expense on convertible debt). [260-10-45-16, 45-40]
- **The denominator is adjusted** to include the shares underlying the potential common shares, as if they were outstanding from the beginning of the period – or for as long as the potential common shares were outstanding (see section 4.4A.40). [260-10-45-16]

The objective in determining diluted EPS is to reflect the maximum possible dilutive effect arising from potential common shares outstanding during the period. Therefore, the effects of any antidilutive potential common shares are ignored, and diluted EPS can never give a more favorable impression of an entity's performance than basic EPS from continuing operations.

There are two general methods for including potential common shares in diluted EPS. When a potential common share is also a participating security, the more dilutive of the relevant methods (i.e. treasury stock or if-converted) and the two-class method is used (see chapter 5).

- **Treasury stock method.** Used for *exercisable* instruments (e.g. options, warrants, certain forward sale contracts and written call options, share-based payment awards). The treasury stock method is also used when an investee concurrently holds an investment in the parent entity (referred to as a reciprocal interest – see section 3.3.80 for NCI considerations). Affects only the denominator, although numerator adjustments may also apply to certain instruments (see section 6.13A.20).
- **If-converted method.** Used for *convertible* instruments (most convertible debt, convertible preferred stock). Affects the numerator and the denominator.



Notes:

1. The reverse treasury stock method is used for certain forward purchase contracts and put options (see section 6.15).
2. A numerator adjustment may be necessary for certain instruments included using the treasury stock method; however, this is independent of the treasury stock method. See section 6.13A.20.
3. Except for certain convertible debt instruments that may be settled in cash or shares (see section 6.13A.30).

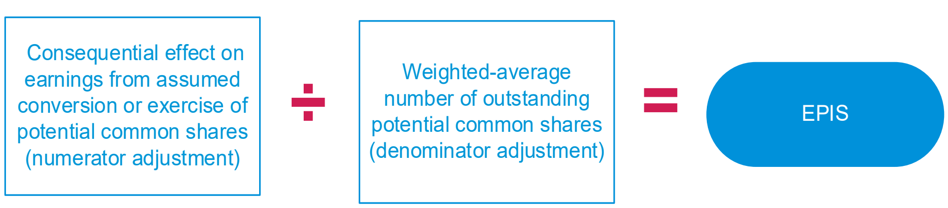
The rest of this Handbook approaches the diluted EPS calculation using the following five-step approach, which is outlined in greater detail in section 4.1.

4.4A Step 2: For each class of potential common shares, determine EPIS

4.4A.10 Overview

The second step to calculating diluted EPS is to determine the 'earnings per incremental share' (or EPIS) for each class of potential common shares, if there is more than one class of potential common shares. Determining EPIS for different classes of potential common shares helps in identifying which of the classes of potential common shares are dilutive and are therefore included in diluted EPS (see section 4.7).

EPIS for a class of potential common shares is determined using the following formula.



Question 4.4A.05

Is it always necessary to determine EPIS when there are multiple classes of potential common shares?

Interpretive response: No. Diluted EPS is only calculated if the effect is dilutive considering income from continuing operations (the control number – see section 4.6). If the control number (i.e. income from continuing operations) is a loss, it may not be necessary to calculate diluted EPS because the effect is likely antidilutive.

Whether to determine EPIS, and calculate diluted EPS, when there is a loss from continuing operations depends on the nature of the potential common shares, and whether they would require a numerator adjustment. If an entity's potential common shares are comprised solely of instruments that affect the EPS denominator only (using the treasury stock or reverse treasury stock methods), the result will always be antidilutive. This is because adding more shares when there is a loss dilutes the loss. In such circumstance, EPIS and diluted EPS do not need to be calculated.

However, in some circumstances, instruments included in diluted EPS using the treasury or reverse treasury stock methods do require a numerator adjustment, and then EPIS and diluted EPS should be calculated (regardless of whether there is a loss from continuing operations) because the overall effect of the numerator and denominator adjustments may be dilutive; see sections 4.4A.30 and 4.6, and section 6.13A. [260-10-45-19]

4.4A.20 The if-converted method

Excerpt from ASC 260-10

• > Convertible Securities and the If-Converted Method

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**…

45-41 In applying the if-converted method, conversion shall not be assumed for purposes of computing diluted EPS if the effect would be antidilutive. Convertible preferred stock is antidilutive whenever the amount of the dividend declared in or accumulated for the current period per common share obtainable on conversion exceeds basic EPS. Similarly, convertible debt is antidilutive whenever its interest (net of tax and nondiscretionary adjustments) per common share obtainable on conversion exceeds basic EPS.

When an entity has convertible instruments (e.g. convertible debt and convertible preferred shares) outstanding at any point during the period, the if-converted method is generally used to calculate the dilutive effect on diluted EPS. The if-converted method assumes that all dilutive potential common shares have been converted into or otherwise resulted in common shares as of the beginning of the period, or from the date the instruments were issued, if later. [260-10-45-40(c)]

Under this assumption, any income, expense or distribution relating to these potential common shares included in income available to common shareholders would not have been recognized. This is because the shareholder cannot share in the income available to a common share and at the same time be entitled to the rights of the original instrument held. For example, interest on a convertible bond would not have been accrued had the bond been converted at the beginning of the period. Accordingly, the numerator is adjusted to reflect any consequential changes in income available to common shareholders that would arise from the assumed conversion of potential common shares (see section 4.4A.30).

Consistent with the general premise that diluted EPS includes only those shares that are dilutive, if applying the if-converted method indicates that the effect of an instrument's conversion is antidilutive, conversion is not assumed and any income, expense or distribution is not an adjustment to the income available to common shareholders. [260-10-45-18]

- Convertible preferred shares are antidilutive under the if-converted method if the return (declared or accumulated) for the period on the preferred shares, per common share, is greater than basic EPS. However, an instrument that is dilutive on its own may be antidilutive when considered in sequence with other instruments (see section 4.5).
- Convertible debt is antidilutive under the if-converted method if the interest during the period, per common share, is greater than basic EPS. However, an instrument that is dilutive on its own may be antidilutive when considered in sequence with other instruments (see section 4.5).

The instruments in these two instances are antidilutive because the related earnings are added back to the numerator in calculating diluted EPS, resulting in additional income available to common shareholders. [260-10-45-18, 45-40]

Observation
Antidilution and participating securities

Assumed conversion or exercise of many participating securities (see chapter 5) may be antidilutive because they already receive an allocation of earnings in calculating basic EPS. Therefore, the securities will only be dilutive if their share of earnings is higher assuming conversion or exercise and this is not offset by the other assumptions inherent in these calculations – e.g. repurchase of common shares with proceeds of exercise for a participating stock option.

4.4A.30 Numerator adjustment

Excerpt from ASC 260-10

• > Computation of Diluted EPS

45-16 … In addition, in computing the dilutive effect of convertible securities, the numerator is adjusted to add back any convertible preferred dividends and the after-tax amount of interest recognized in the period associated with any convertible debt. The numerator also is adjusted for any other changes in income or loss that would result from the assumed conversion of those potential common shares, such as profit-sharing expenses. Similar adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods…

• > Convertible Securities and the If-Converted Method

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.
b. If an entity has convertible debt outstanding:
   1. Interest charges applicable to the convertible debt shall be added back to the numerator.
   2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.
   3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).
c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator.

• > Contracts That May Be Settled in Stock or Cash

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b). The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

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45-16 ... In ~~addition, in~~ computing the dilutive effect of convertible securities, the numerator is adjusted in accordance with the guidance in paragraph 260-10-45-40. ~~to add back any convertible preferred dividends and the after-tax amount of interest recognized in the period associated with any convertible debt. The numerator also is adjusted for any other changes in income or loss that would result from the assumed conversion of those potential common shares, such as profit-sharing expenses. Similar adjustments~~ Adjustments also may be necessary for certain contracts that provide the issuer or holder with a choice between settlement methods…

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.
b. If an entity has convertible debt outstanding:
   1. Interest charges applicable to the convertible debt shall be added back to the numerator. For convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator.
   2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.
   3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).
c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator. See paragraph 260-10-45-21A if the incremental shares are variable (such as when calculating a conversion premium).

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b). ~~The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.~~

Under the if-converted method, the numerator is adjusted for the after-tax effect of: [260-10-45-40]

— any dividends, interest and other items related to the dilutive potential common shares that are deducted in arriving at the income available to common shareholders; and

— any other changes in income or expense that would result from the assumed conversion of dilutive potential common shares.

A numerator adjustment is also made when the accounting classification of an instrument differs from its settlement assumption, even if the instrument is not included in diluted EPS using the if-converted method.

For example, a share-based payment award is liability-classified because it may be settled in cash or shares. The award is included in diluted EPS using the treasury stock method, which includes only a denominator adjustment (see section 4.4A.40). However, if share settlement is presumed for EPS purposes, the numerator is also adjusted to reverse the income statement effect of the fair value (mark-to-market) adjustment for the liability-classified award (classified as such for accounting purposes); the instrument would not have been marked to market had it been accounted for as share-settled.

The following table illustrates when instruments generally may incur a numerator adjustment (before adoption of ASU 2020-06).

Classification	Instrument	Numerator adjustment?	Commentary
Equity-classified	**Options and warrants**	✗	Generally no numerator adjustment unless cash settlement is presumed for EPS. See section 6.13A.
	Prepaid forward sale contracts	✗	Generally no numerator adjustment unless cash settlement is presumed for EPS. See section 6.13A.
	Prepaid forward purchase contract or written put option	✗	Generally no numerator adjustment unless cash settlement is presumed for EPS. See sections 6.13A and 6.15.
Liability-classified	**Options and warrants**	?	Numerator adjustment if share settlement is required or presumed for EPS. See section 6.13A.
	Forward sale contract	?	Numerator adjustment if share settlement is required or presumed for EPS. See section 6.13A.

Classification	Instrument	Numerator adjustment?	Commentary
	Forward purchase contract or written put option	?	Numerator adjustment if share settlement is required or presumed for EPS. See sections 6.13A and 6.15.
Equity- or liability-classified	**Purchased put and call options**	✗	Not included in diluted EPS because doing so would be antidilutive.
	Convertible debt – conversion option not bifurcated	✓	Generally, there is a numerator adjustment (e.g. interest expense); however, it is not made if cash settlement of the principal is required or presumed. See section 6.13A.
	Convertible debt with bifurcated conversion option	✓	Generally, there is a numerator adjustment (e.g. interest expense, mark-to-market adjustment); however, it is not made if cash settlement is required or presumed. See section 6.13A.

Question 4.4A.10

What is included in the 'interest and other items' numerator adjustment for diluted EPS?

Interpretive response: Interest charges applicable to convertible debt are added back to the numerator of the EPS calculation under the if-converted method; this is because these charges would not have been incurred had the debt been converted at the beginning of the period (see note). These charges include interest charges related to the amortization of debt issuance costs, debt discounts or premiums and other yield adjustments. Also included are gains/losses on the extinguishment of debt for those instruments extinguished during the period. A gain/loss for a hypothetical extinguishment on outstanding instruments would not be included in the if-converted method. [260-10-45-40(b)(1)]

'Other items' may also include fair value adjustments. For liability-classified instruments that are share-settled for EPS purposes (i.e. these instruments may be settled in stock or cash), any fair value adjustments that are recognized in income (because the instrument or a related derivative conversion option is recorded at fair value), also result in an adjustment to the numerator. [260-10-55-32, 55-36A]

Note: On adoption of ASU 2020-06, interest charges are not added back to the numerator for a convertible instrument when the principal amount is required to be settled in cash. See section 6.13.

Examples of numerator adjustments include the following.

Instrument	Numerator adjustments[1]
Convertible debt	— Interest expense recognized during the period (before adoption of ASU 2020-06). — Interest expense recognized during the period for convertible debt settled in stock (after adoption of ASU 2020-06; see section 6.13A.30. — Nondiscretionary adjustments[2] recognized during the period. — Mark-to-market adjustment recognized on the convertible debt instrument. — Gains or losses recognized on settlement of convertible debt.
Convertible preferred stock	— Dividends that reduced the numerator during the reporting period, including deemed dividends recognized on the settlement of the preferred stock instrument that reduce the numerator. — Nondiscretionary adjustments[2] recognized during the period. — Mark-to-market adjustment recognized on the convertible preferred stock instrument.

Notes:

1. Adjustments include the relevant income tax effects.
2. To meet the definition of a nondiscretionary adjustment (e.g. changes that are made to profit-sharing plans), an income statement item must:
   - be calculated on the basis of net income or similar measure; and
   - arise from a contractual right or obligation of the entity, if interest expense was not recognized on the convertible debt.

Example 4.4A.10
Numerator adjustments for convertible debt

ABC Corp. issues traditional convertible debt that is accounted for wholly as a financial liability under Topic 470 (debt).

If the convertible debt is dilutive, the relevant adjustments for the debt include:

— the after-tax effect of interest expense that would have been saved from the assumed conversion of the convertible debt – e.g. amortization of initial transaction costs and premiums or discounts accounted for using the effective interest method under Subtopic 835-30 (imputation of interest); see section 6.12A for an illustration of this adjustment;

— the after-tax effect of foreign exchange gain or loss in earnings, if the instrument is denominated in a foreign currency; and

— the after-tax effect of any fair value remeasurement, if ABC elects the fair value option to account for the instrument.

Question 4.4A.20

Other than dividend and interest charges, what other adjustments may be made to the numerator in diluted EPS?

Interpretive response: Besides requiring that dividends and interest on convertible instruments be added back to the numerator, any other direct changes in income or loss that would result from the assumed conversion of potential common shares are adjusted (see Question 4.4A.10). Topic 260 notes that the conversion of potential common shares may lead to consequential changes in earnings, such as profit-sharing expenses. [260-10-45-16, 45-40(b)(2)]

Examples of other consequential effects on income or loss include:

— a decrease in depreciation expense if part of the interest on the debt has been capitalized and is being depreciated under Subtopic 835-20 (capitalization of interest). This is because had the convertible instrument been converted already, there would be no related interest included in depreciation expense; and

— an increase in the expense related to a nondiscretionary employee profit-sharing plan.

We believe that for an item to be treated as having an effect on income as a result of an assumed conversion of dilutive potential common shares, there should be a direct or automatic adjustment to income or loss.

Observation

Interest capitalized during the period

The interest component of depreciation expense that is capitalized as a result of applying the guidance in Subtopic 835-20, is an adjustment to the numerator of diluted EPS (see Question 4.4A.20); however, capitalized interest in general is not. This is because interest that is capitalized is not considered an expense or charge during the period to which paragraph 260-10-45-16 applies.

However, an entity considers whether a different amount of interest would have been capitalized on *other* debt had the convertible instruments been converted at the beginning of the period. This can be done by a 'with and without' calculation. If the amount of interest capitalized would have been different if the convertible instrument was not outstanding at the beginning of the period, then interest expense (in the income statement) would also have been different. This difference (between the interest that *was* capitalized and interest that *would have been* capitalized) is a nondiscretionary adjustment to the numerator. [260-10-45-40]

Question 4.4A.30

Should inducement costs be removed from the numerator in calculating diluted EPS?

Interpretive response: Yes. Because the if-converted method assumes conversion based on the instrument's existing terms as of the beginning of the period, inducement costs generally would not have been incurred if earlier conversion had occurred.

It is inconsistent to assume conversion as of the beginning of the period and also include an inducement charge in the numerator. Therefore, these costs, which reduce income used in the basic EPS numerator, are reversed (i.e. added back to income) in calculating diluted EPS using the if-converted method.

However, how the inducement costs are removed depends on whether the instrument is equity- or liability-classified.

Equity-classified instruments (including those classified in temporary equity)

Inducement costs recognized on equity-classified convertible preferred shares during the period are treated as a deemed dividend and are deducted from income available to common shareholders when calculating basic EPS (see section 3.3A.50). This adjustment is reversed when calculating diluted EPS using the if-converted method.

Liability-classified instruments

Inducement costs for liability-classified instruments are recognized in earnings. Therefore, unlike equity-classified securities, there is no dividend on preferred shares adjustment in the numerator for basic EPS, and no reversal of that adjustment in calculating diluted EPS.

However, in calculating diluted EPS using the if-converted method, expenses and charges recognized in earnings during a period related to the induced conversion of convertible securities (whether liability-classified preferred shares or convertible debt) generally result in an adjustment to the numerator – i.e. they are added back to the numerator to arrive at income available to common shareholders for diluted EPS.

For example, if an entity induces its convertible debt holders to convert through an additional cash payment, the entity adds back the inducement expense to the numerator to calculate its diluted EPS. [260-10-45-16]

Question 4.4A.35

How does a redemption or induced conversion of only a portion of outstanding securities affect the numerator in calculating diluted EPS?

Interpretive response: When only a portion of outstanding securities of a given class of securities is redeemed or converted under an inducement offer, to determine whether the if-converted method is dilutive for the period, an entity should: [260-10-S99-2]

— attribute excess consideration (inducement charges) to those securities that it redeems or converts; and

— consider the securities redeemed or converted separately (i.e. those redeemed/converted are a separate class) from those not redeemed or converted.

For example, for an induced conversion the numerator adjustment – i.e. inducement costs that are reversed in the if-converted method (see Question 4.4A.30) is allocated to the converted class of securities when determining EPIS (see section 4.4A.50).

Example 4.4A.20

Other changes in income or loss that would result from an assumed conversion

Scenario 1: Numerator adjustment – consequential effect on employee profit-sharing plan expense

— On January 1, Year 1, ABC Corp. issues a bond that is convertible into its common shares. During Year 1, interest expense recognized on the debt is $1,000.

— ABC has a nondiscretionary employee profit-sharing plan that pays 5% of its income before tax annually to all eligible employees.

— All expenses are tax-deductible. The applicable income tax rate is 21%.

Diluted EPS – EPIS numerator adjustment – Year 1

To determine EPIS for the convertible bond, ABC assumes that the bond is converted into common shares at the beginning of Year 1.

With the assumed conversion, the interest on the bond would not have been recognized in Year 1. This would have resulted in an increase in income for Year 1 and would have automatically led to an increase in the employee profit-sharing plan expense.

Step	Diluted EPS
1	**Identify potential common shares** The convertible bond represents potential common shares.
2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:*

	Before tax	Related tax	After tax
Decrease in interest expense	$1,000	$(210) [$1,000 × 21%]	**$790**
Increase in employee profit-sharing expense	(50) [$1,000 × 5%]	11 [$50 × 21%]	**(39)**
Numerator adjustment	**$950**	**$(199)**	**$751**

Scenario 2: Numerator adjustment – consequential effect on capitalized borrowing costs

— On January 1, Year 1, ABC Corp. issues a bond that is convertible into its common shares.

— During Year 1, ABC recognizes interest on the bond of $9,000, of which $6,000 is recognized in earnings and $3,000 is capitalized into the cost of property, plant and equipment under Subtopic 835-20. There are no other borrowing costs incurred during the period.

— Of the interest of $3,000 capitalized during Year 1, $500 is recognized as part of depreciation expense in Year 1.

— All expenses are tax-deductible. The applicable income tax rate is 21%.

To determine EPIS for the convertible bond, ABC assumes that the bond is converted into common shares at the beginning of Year 1.

With the assumed conversion, the interest on the bond would not have been recognized in Year 1. In addition to the reduction in interest expense, there would have been a reduction in the interest capitalized and therefore a reduction in depreciation expense recognized during Year 1.

Diluted EPS – EPIS numerator adjustment – Year 1

Step	Diluted EPS
1	**Identify potential common shares** The convertible bond represents potential common shares.
2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:*

	Before tax	Related tax	After tax
Decrease in interest expense	$6,000	$(1,260) [$6,000 × 21%]	**$4,740**
Decrease in depreciation expense	500	(105) [$500 × 21%]	**395**
Numerator adjustment	**$6,500**	**$(1,365)**	**$5,135**

Accordingly, the numerator adjustment is $5,135.

Scenario 3: Numerator adjustment – no consequential effect on income

ABC Corp. issues stock options to its employees. To fulfill its related obligations, ABC writes a call option to Bank Z to purchase its own shares at market price, assuming no liquidity issues for their securities. ABC concludes that this call option is a derivative with a fair value of zero because the call option allows ABC to purchase shares at market price.

Therefore, as far as the call option between ABC and Bank Z is concerned, there will be no impact to earnings; this is because the derivative will always be at fair value and there is no mark to market gain or loss. Accordingly, no numerator adjustment is made to EPIS.

Scenario 4: Numerator adjustment – no consequential effect on income

Continuing Scenario 3, to reduce its exposure to an increase in the market price of its shares when the stock options become exercisable, ABC enters into a share swap with Bank Y.

- ABC takes a notional loan from Bank Y, with the principal amount equal to the purchase price of a notional number of shares at a notional share price.
- ABC pays interest on the notional loan and Bank Y pays dividends on the notional number of shares when ABC declares dividends.
- ABC may change the number of notional shares implicit in the notional loan by notifying Bank Y in advance and intends to reduce the number of notional shares in line with the reduction in share options outstanding. The difference between the notional price and the market price of shares is refunded by Bank Y if the number of shares decreases, and vice versa.

Although ABC may intend to adjust the notional amount under the swap arrangement to hedge the share-based payment liability, the adjustment is not automatic, and ABC has the discretion to adjust its exposure.

Therefore, we believe there is not sufficient linkage between the swap arrangement with Bank Y and the exercise of options to consider changes in the swap arrangement with Y to be a direct change to income. Accordingly, no numerator adjustment is made to EPIS in this regard.

Question 4.4A.40

Is a numerator adjustment ever made for share-based payment expense?

Interpretive response: Generally, no. Share-based payments are included in diluted EPS using the treasury stock method, not the if-converted method (see section 4.4A.40). We believe the numerator should not be adjusted for equity-settled share-based payment costs when calculating diluted EPS.

A numerator adjustment might be made for liability-classified share-based payment awards under a share-settlement presumption, but a numerator adjustment would not be made for liability-classified awards that are expected to be cash-settled. This is because they are not included in diluted EPS (see section 6.9A.20).

Question 4.4A.45

Is the income tax effect of numerator adjustments reflected in diluted EPS?

Interpretive response: Yes. The income tax effect of numerator adjustments is reflected in the calculation of EPS. The income tax effect is based on the Topic 740 calculated amount. [260-10-45-40(b)(3)]

Example 4.4A.25

Calculation of applicable tax rate for numerator adjustments

ABC is domiciled in the United States and issues bonds that are convertible into its common shares. The bonds may be settled by ABC in any combination of cash or common shares (Instrument X). During the year, interest expense recognized on the debt is $1,000, which is tax deductible.

ABC also has operations in Canada and China that represent approximately 50% of its global sales. The applicable tax rates in the United States, Canada and China are 21%, 26.5% and 25%, respectively.

Because ABC is domiciled in the United States, it calculates the after-tax effect of the interest expense adjustment as $790 under the if-converted method, using the 21% tax rate: $1,000 × (1 - 21%).

4.4A.40 Denominator adjustment, including the treasury stock method

Excerpt from ASC 260-10

• > Convertible Securities and the If-Converted Method

45-42 Dilutive securities that are issued during a period and dilutive convertible securities for which conversion options lapse, for which preferred stock is redeemed, or for which related debt is extinguished during a period, shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive convertible securities converted during a period shall be included in the denominator for the period prior to actual conversion. The common shares issued upon actual conversion shall be included in the denominator for the period after the date of conversion. Consequently, shares assumed issued shall be weighted for the period the convertible securities were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

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• > ~~>>>~~ Average Market Price

55-4 ~~In applying the **treasury stock method**, the~~The average market price of **common stock** shall represent a meaningful average. Theoretically, every market transaction for an entity's common stock could be included in determining the average market price. As a practical matter, however, a simple average of weekly or monthly prices usually will be adequate.

55-5 Generally, closing market prices are adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the high and low prices for the period that the price represents usually would produce a more representative price. The method used to compute the average market price shall be used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to compute the average market price for several years of relatively stable market prices might need to change to an average of high and low prices if prices start fluctuating greatly and the closing market prices no longer produce a representative average market price.

The denominator for diluted EPS is the weighted-average number of common shares used in calculating basic EPS (see section 3.4) plus the number of common shares that would be issued on conversion of all of the dilutive potential common shares into common shares.

Weighted-average number of common shares used in calculating basic EPS (see section 3.4) + Number of common shares that would be issued on conversion of all of the dilutive potential common shares into common shares = **Denominator for diluted EPS**

When determining EPIS for different classes of potential common shares, the shares are weighted for the period they are outstanding. Accordingly, they are included in the denominator for diluted EPS from the beginning of the reporting period, or from the date they are issued if this is later. Potential common shares that were cancelled, allowed to lapse or converted to common shares during the reporting period are included for the period they are outstanding – i.e. until the date on which they were cancelled, lapsed or converted. [260-10-45-42]

Similar to the denominator for basic EPS, when determining the denominator for diluted EPS, strictly speaking, the time-weighting factor is the number of days that the potential common shares are outstanding as a proportion of the total number of days in the period. However, a reasonable approximation is adequate in many circumstances. This might involve using monthly averages, weeks, parts of months or whole months, rather than the precise number of days. [260-10-55-2]

Example 4.4A.30
Denominator adjustment – if-converted method

ABC Corp. has the following transactions involving its noncumulative preferred shares during Year 1. All of these preferred shares are convertible into common shares on the same conversion terms; each share of preferred is convertible into one share of common.

Dates in Year 1	Transaction	Preferred shares
January 1	Balance	2,000
April 1	Preferred shares converted into common shares	(500)
July 1	Preferred shares issued	1,000
December 31	**Balance**	**2,500**

Diluted EPS – EPIS denominator adjustment

Step	Diluted EPS
1	**Identify potential common shares** The convertible preferred shares represent potential common shares.
2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* [Not relevant to this example.] *Potential adjustment to the denominator for EPIS:*

	No. of shares outstanding	Time weighting	Weighted-average no. of shares
January 1 – March 31	2,000	3/12	500
April 1 – preferred shares converted	(500)		
April 1 – June 30	1,500	3/12	375
July 1 – preferred shares issued	1,000		
July 1 – December 31	2,500	6/12	1,250
		12/12	
Weighted-average for the year			**2,125**

Therefore, the denominator adjustment for EPS of preferred shares is 2,125.

Denominator adjustment for options, warrants and their equivalents – the treasury stock method

Excerpt from ASC 260-10

• > Options, Warrants, and Their Equivalents and the Treasury Stock Method

45-22 The dilutive effect of outstanding call options and warrants (and their equivalents) issued by the reporting entity shall be reflected in diluted EPS by application of the treasury stock method unless the provisions of paragraphs 260-10-45-35 through 45-36 and 260-10-55-8 through 55-11 require that another method be applied. Equivalents of options and warrants include nonvested stock granted under a share-based payment arrangement, stock purchase contracts, and partially paid stock subscriptions (see paragraph 260-10-55-23). Antidilutive contracts, such as purchased put options and **purchased call options**, shall be excluded from diluted EPS.

45-23 Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. (See paragraphs 260-10-45-29 and 260-10-55-4 through 55-5
c. The incremental shares (the 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.

• • > Average Market Price

55-4 In applying the **treasury stock method**, the average market price of **common stock** shall represent a meaningful average. Theoretically, every market transaction for an entity's common stock could be included in determining the average market price. As a practical matter, however, a simple average of weekly or monthly prices usually will be adequate.

55-5 Generally, closing market prices are adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the high and low prices for the period that the price represents usually would produce a more representative price. The method used to compute the average market price shall be used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to compute the average market price for several years of relatively stable market prices might need to change to an average of high and low prices if prices start fluctuating greatly and the closing market prices no longer produce a representative average market price.

Pending Content

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45-23 Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. (See paragraphs 260-10-45-29 and 260-10-55-4 through 55-5.)
c. The incremental shares (the 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.

Example 15 (see paragraph 260-10-55-92) provides an illustration of this guidance. <u>See paragraph 260-10-45-21A if the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument is variable.</u>

<u>• ></u> ~~> > >~~ Average Market Price

55-4 ~~In applying the **treasury stock method**, the~~ <u>The</u> average market price of **common stock** shall represent a meaningful average. Theoretically, every market transaction for an entity's common stock could be included in determining the average market price. As a practical matter, however, a simple average of weekly or monthly prices usually will be adequate.

55-5 Generally, closing market prices are adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the high and low prices for the period that the price represents usually would produce a more representative price. The method used to compute the average market price shall be used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to compute the average market price for several years of relatively stable market prices might need to change to an average of high and low prices if prices start fluctuating greatly and the closing market prices no longer produce a representative average market price.

In addition to the general principles described so far in this chapter, specific requirements apply when determining the denominator adjustment for different types of potential common shares. For example, for options, warrants and their equivalents, rather than simply adding to the denominator the weighted-average number of common shares to be issued from the assumed conversion of the options, Topic 260 prescribes another method – the treasury stock method.

Under the treasury stock method, the proceeds from the instrument's exercise are assumed to be used to repurchase common shares at the average market price during the period, and only the incremental shares (excess of the shares issued on exercise less the shares repurchased) are included in the denominator.

The following diagram summarizes the treasury stock method for instruments other than those issued in share-based payment arrangements.

The treasury stock method

Step i	**Calculate the assumed proceeds** Calculate the proceeds that would have been received from the assumed exercise of all options.	'Exercise price' x number of options
Step ii	**Calculate the incremental shares deemed to be repurchased at average market price** Calculate the number of common shares that would have been repurchased if the proceeds received in Step (i) were used to acquire these shares at their average market price during the period.	Assumed proceeds ÷ average market price of shares
Step iii	**Determine the incremental shares** Calculate the difference between the number of common shares that would be issued at the exercise of the options and the number of common shares deemed to be repurchased at the average market price.	Number of shares that would be issued – number of shares deemed to be repurchased

The denominator in the year-to-date period is calculated using an average of the quarterly denominators, as discussed in section 8.3.30.

For further discussion of the treasury stock method, see section 6.9A.30. For further discussion of how the treasury stock method is applied to share-based payment arrangements, see section 6.9A.40.

In applying the treasury stock method to awards accounted for under Topic 718, the awards may be antidilutive even when the market price of the underlying share exceeds the related exercise price. This is because compensation cost attributed to future services and not yet recognized is included as a component of assumed proceeds in applying the treasury stock method.

In addition to the treasury stock method, there is also the reverse treasury stock method (see section 6.15.30). These two methods are used to calculate the effect on diluted EPS for the following instruments.

Instrument	Method	Discussion
Partially paid common shares	Treasury stock method	Section 6.3
Unvested common shares	Treasury stock method	Section 6.8
Written put options	Reverse treasury stock method	Section 6.15
Written call options ('options')	Treasury stock method	Section 6.8
Written forward purchase contracts	Reverse treasury stock method	Section 6.15
Written forward sale contracts	Treasury stock method	Section 6.8

For further discussion of the denominator adjustment for other specific types of potential common shares, see chapter 6.

Question 4.4A.50

How is the average market price of common shares determined when applying the treasury stock method?

Interpretive response: The average market price is determined based on:

- the full reporting period; or
- the period for which the options are outstanding if this is shorter (see section 6.9A).

For example, if the options are outstanding only for six months of the reporting period, in determining the incremental shares the average market price is based on the average market price during that six-month period.

An entity that has multiple issuances of the same instrument during the period performs a separate average market price calculation for each issuance. This is because the instruments were outstanding for different time periods during the reporting period, and the share prices may have been different during those periods. However, when an entity only has one instrument, it may apply a weighted-average approach to calculate the number of potential common shares outstanding and then apply the average market price of the shares for the entire period the instruments were outstanding. See Example 4.4A.35.

For entities that report quarterly information, see section 8.3.30 for guidance on year-to-date calculations.

Quoted market prices available

When determining the average market price for a period, in theory every market transaction could be included. However, as a practical matter a simple average of weekly or monthly prices is usually adequate. [260-10-55-4]

While closing market prices are generally adequate for calculating the average market price, when the share price fluctuates widely, the closing price may not be an appropriate representation. In that case, a daily average (not merely a simple average) of the high and low prices is usually more representative. However, we believe an entity should not consider pre- or post-market trading when calculating the average share price. [260-10-55-5]

When an entity's shares are not actively traded, we believe it may be appropriate to use the average of the bid and ask prices because there is less market activity for the shares.

The method used to calculate the average market price is used consistently unless it is no longer representative because conditions have changed. For example, if an entity uses closing market prices to calculate the average market price for several years, but prices then start fluctuating significantly, it might need to change to an average of high and low prices. [260-10-55-5]

Quoted market prices not available

In some cases, there may not be a quoted market price for the common shares for the full period. For example, this may be the case if the entity does not have common shares or potential common shares that are publicly traded but the entity elects to disclose EPS, or if the entity's common shares or potential common shares were not listed for the full period.

For example, an entity with an annual reporting period ending on December 31, Year 1 lists its common shares on November 7, Year 1, so that it has a quoted market price for its shares only during the period from November 7 – December 31, Year 1.

We believe that if the average market price of the shares is necessary to calculate diluted EPS (e.g. because the entity has outstanding warrants or options for the entire year), the average market price used should be a meaningful average for the full reporting period, or the period for which the potential common shares are outstanding if this is shorter.

We do not believe an average market price for approximately two months in the above example would be meaningful for potential common shares outstanding for the full year.

Further, if there is no active market for common shares, we believe the entity should determine fair value using valuation techniques (using the guidance in Topic 820). See KPMG Handbook, Fair value measurement. The use of a valuation professional may be required in this assessment. Also, an entity should consider valuations made for other purposes, such as for share-based payment grants, and the consistency of inputs and methods used.

The method used to determine the average market price is disclosed in the notes to the financial statements. [235-10-50-3, SEC FRM 9520.1]

Question 4.4A.55

How is the average market price of common shares determined when there is a spinoff?

Interpretive response: Certain transactions, such as a spinoff, may result in a change in the fair value of the market price. An entity does not adjust historical market prices to reflect the effect of any changes from the spinoff transaction (i.e. as if the transaction had occurred in a prior period). Therefore, historical average market prices, when applying the treasury stock method, are not adjusted as if the transaction had occurred in a prior period. [260-10-45-21]

Example 4.4A.35

Weighted-average potential common shares – treasury stock method

On January 1, ABC Corp. has 2,000 stock options outstanding. On April 1,500 stock options were exercised, and on July 1 an additional 1,000 stock options were granted.

The stock options all have the same terms, and ABC performs the treasury stock method considering the various stock option issuances as one class of potential common shares. It calculates a weighted-average number of instruments outstanding during the year as follows.

	No. of shares outstanding	Time weighting	Weighted-average no. of shares
January 1 – March 31	2,000	3/12	500
April 1 – stock options exercised	(500)		
April 1 – June 30	1,500	3/12	375
July 1 – stock options granted	1,000		
July 1 – December 31	2,500	6/12	1,250
		12/12	
Weighted average for the year			**2,125**

Therefore, ABC includes 2,125 stock options in its treasury stock method calculation.

Observation
Stock options and warrants that are out-of-the-money

Stock options or warrants that are out-of-the-money from the holder's perspective at the reporting date are not assumed to be exercised for purposes of applying the treasury stock method. These instruments are not included in diluted EPS, and it is not necessary to determine if they are dilutive or not until they are in-the-money. This is because, under the treasury stock method, the proceeds from the assumed exercise of the instruments are used to repurchase the shares at the average market price, and only the incremental (i.e. remaining) shares are added to the denominator (see example 4.4A.50). If the exercise price is greater than average market price, there are no incremental shares to add to the denominator, meaning there is no dilution. The same applies to share-based payment awards in the form of options and unvested shares. [260-10-45-25, 45-28A]

Section 6.9A.20 discusses when options and warrants, including share-based payment awards, are in-the-money.

Example 4.4A.40
Average share price before IPO

ABC Corp. completes an initial public offering (IPO) on June 1 and can measure the fair value of its shares from June 1 through December 31. However, ABC has difficulty determining its average market price before the IPO.

In applying the treasury stock method, ABC cannot assume that the IPO price is the average market price from January 1 through May 31. If ABC had obtained a stock option price valuation the previous June, it should review that report to determine a meaningful average market price. ABC should update the valuation report for changes in the price of its shares up to the IPO date.

Note: A nonpublic entity should look at valuation reports when measuring compensation or facilitating business combinations to develop meaningful average prices for periods in which its shares were not publicly traded.

Example 4.4A.50
Treasury stock method calculation for options and warrants

ABC Corp. previously issued an equity-classified warrant in a financing transaction that allows the holder to purchase 10,000 common shares of ABC stock at $54 per share. The average market price of ABC's common stock during the reporting period is $60 and the warrant is outstanding throughout the period.

ABC assumes exercise of the warrants and issuance of 10,000 shares of common stock for the treasury stock calculation. The $540,000 that ABC would realize from exercise of the warrant ($54 × 10,000) is sufficient to repurchase 9,000 shares of its common stock ($540,000 ÷ $60) based on the average price of ABC common shares during the period. Therefore, ABC adds 1,000 incremental shares (10,000 – 9,000) to the denominator when calculating diluted EPS for the period.

Note: This method applies to written call options and warrants that allow the investor to purchase an entity's common shares in exchange for cash or other assets – or that do not require additional transfer of consideration, such as restricted shares. Certain adjustments are necessary for other types of options (see section 6.9A).

Multiple conversion or exercise bases

Excerpt from ASC 260-10

• > Conversion Rate or Exercise Price

45-21 Diluted EPS shall be based on the most advantageous **conversion rate** or **exercise price** from the standpoint of the **security** holder. Previously reported diluted EPS data shall not be retroactively adjusted for subsequent conversions or subsequent changes in the market price of the common stock.

• > Contracts That May Be Settled in Stock or Cash

45-45 If an entity issues a contract that may be settled in common stock or in cash at the election of either the entity or the holder, the determination of whether that contract shall be reflected in the computation of diluted EPS shall be made based on the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Topic) if the effect is more dilutive. Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46. An example of such a contract is a written put option that gives the holder a choice of settling in common stock or in cash.

• • > Options and Warrants and Their Equivalents

55-8 When several conversion alternatives exist, the computation shall give effect to the alternative that is most advantageous to the holder of the convertible security. Similar treatment shall be given to **preferred stock** that has similar provisions or to other securities that have conversion options that permit the investor to pay cash for a more favorable **conversion rate.**

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

• > Variable Denominator

45-21A Changes in an entity's share price may affect the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument. For example, when the principal of a convertible debt instrument is required to be settled in cash but the conversion premium is required to (or may) be settled in shares, the number of shares to be included in the diluted EPS denominator is affected by the entity's share price. In applying both the treasury stock method and the if-converted method of calculating diluted EPS, the average market price shall be used for purposes of calculating the denominator for diluted EPS when the number of shares that may be issued is variable, except for contingently issuable shares within the scope of the guidance in paragraphs 260-10-45-48 through 45-57. See paragraphs 260-10-55-4 through 55-5 for implementation guidance on determining an average market price.

Some types of potential common shares have more than one basis of conversion – e.g. the manner of conversion is at the discretion of one of the contracting parties, or the conversion rates or exercise prices vary over time. When determining the effect of these potential common shares on diluted EPS, the general principle is that the diluted EPS should capture the maximum dilutive effect arising from potential common shares outstanding during the period. This generally means the following.

— **Contracts whose conversion rate or exercise price varies over time.** Use the most advantageous conversion rate or exercise price, from the standpoint of the holder of the potential common shares, that is available to the holder for the remainder of the contract. [260-10-45-21]

— **Contracts that may be settled in common shares or cash at the entity's option.** Assume the contract will be settled in common shares, if more dilutive, unless (1) there is past experience or a stated policy that supports cash settlement, and (2) the entity can demonstrate its intent and ability to cash settle the contract. [260-10-45-45 – 45-46]

— **Contracts that may be settled in common shares or cash at the holder's option.** Use the more dilutive of share-settlement and cash-settlement. [260-10-55-36]

However, if the holder has an advantage by choosing one alternative over another (i.e. a more favorable conversion rate if settled in cash), the alternative that is more advantageous to the holder is assumed. [260-10-55-8]

When the conversion rate or exercise price assumed in the EPS calculation varies between the periods presented, previously reported EPS amounts are not adjusted to reflect the change. [260-10-45-21]

For further guidance and examples on how the conversion options affect diluted EPS, in addition to the questions below, see sections 6.12A and 6.13A.

Question 4.4A.60

What conversion rate is used for convertible instruments (share-settled) when the rate is based on the market price?

Background: An entity may have outstanding convertible preferred shares or convertible debt that is required to be exchanged into common shares at an exchange ratio based on the market price of the entity's common shares on a specific date for a fixed monetary amount (share-settled instruments).

Interpretive response: In applying the if-converted method to such instruments, we believe the entity should use the market price of its common shares at the end of the period to determine the exchange ratio. Alternatively, if the exchange formula is based on an average for a certain number of days preceding the exchange, we believe the entity should use the average share price in that same number of days leading up to the end of the period. Because the instruments do not have a fixed exchange ratio, the number of shares the entity will issue is calculated using the guidance on contingently issuable shares in paragraph 260-10-45-48 and 45-52 (see section 6.10).

However, an entity should not project future conversion rates or exercise prices.

Question 4.4A.70

What exercise price is used when the exercise price is based on the common share market price?

Background: Some agreements establish the exercise price of the instrument as a percentage of the average market price over a specified number of days. In applying the treasury stock method to calculate diluted EPS, an entity calculates the number of potential common shares to be added to the denominator using the market price formula, specifying as the market price input the average of the prices for the specified period immediately preceding the period end.

Interpretive response: This methodology is consistent with the guidance on contingently issuable shares, which states that diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period if the effect is dilutive (see section 6.10).

However, an entity should not project future conversion rates or exercise prices.

Question 4.4A.80

Does diluted EPS consider potential changes to the conversion rate or exercise price that are contingent on changes in the market or future events?

Interpretive response: No. We believe that only changes to the conversion rates or exercise price that are available solely due to the passage of time should be considered in diluted EPS, and the conversion rate or exercise price that is most advantageous to the holder should be used. [260-10-45-21, 55-8]

If the conversion rate or exercise price is based on a market price, the conversion rate or exercise price applicable to the market price at period-end is used; or the average market price during the period, if the conversion rate or exercise price is based on an average market price. See Questions 4.4A.60 and 4.4A.70.

Changes that are contingent on the occurrence or nonoccurrence of a future event, such as a secondary offering or a change of control, are only considered when the event actually occurs. [260-10-45-48]

If changes are contingent upon the satisfaction of a condition (i.e. a specified market price or earnings target), the guidance on contingently issuable shares applies. See sections 6.10 and 6.11, and Question 4.4A.90. [260-10-45-48]

Question 4.4A.90

What number of shares is used when the number of shares is variable?

Interpretive response: When the number of shares to be issued is variable, based only on the passage of time, we believe an entity should analogize to the guidance in paragraph 260-10-45-21 and uses the number of shares that is most advantageous to the holder for the remainder of the contract. For example, if the entity issues bonds that are convertible into 100 shares after one year, and 150 shares after two years, the entity considers 150 shares when calculating diluted EPS.

Alternatively, if the number of shares is variable based on the occurrence or nonoccurrence of a future event, or the satisfaction of a condition (i.e. a specified market price or earnings target), the guidance on contingently issuable shares applies. See sections 6.10 and 6.11, and Question 4.4A.80. [260-10-45-21, 45-48, 55-8]

Observation

Number of shares to be issued vs number of shares to be included in diluted EPS under the treasury stock method

When the *number of shares to be issued* is variable, an entity uses the most advantageous share price – or, if based on a contingency, the share price relevant to the status of the contingency – to determine the number of shares to be issued (see Question 4.4A.90). However, to determine the *incremental shares* to be included in diluted EPS, the average share price is always used.

Question 4.4A.100

How does an exercise or conversion price adjustment based on future dividends affect diluted EPS?

Interpretive response: It depends on whether the adjustment is based on actual dividends declared or if it is a predefined adjustment that is intended to account for future anticipated dividends. If the adjustment is based on actual dividends, the instrument may be a participating security (see Question 5.2.50). However, an entity should not project future dividends.

Changes in the number of potential common shares outstanding without corresponding changes in capital resources

Similar to the denominator for basic EPS (see sections 3.4 and 6.2), the denominator for diluted EPS may be affected if the number of potential common shares outstanding increases or decreases without a corresponding change in capital resources – e.g. as a result of a stock dividend, stock split or reverse stock split.

Many types of potential common shares contain antidilution provisions that protect their holders from devaluation of their rights. For example, the terms of a stock option may specify that its conversion ratio be adjusted in the event of a stock split. If there is a change in the number of outstanding common shares without a corresponding change in capital resources, the terms of potential common shares outstanding at the time of the change are evaluated to determine whether there is a corresponding change in the number of potential common shares outstanding and therefore a corresponding adjustment to the denominator for the diluted EPS calculation. In such situations, EPS is retrospectively adjusted for all periods presented (see section 7.2.20).

4.4A.50 Determining EPIS

Once the adjustments to the numerator and the denominator have been determined, EPIS is calculated using the formula in section 4.4A.10.

Question 4.4A.110

Can instruments be combined when calculating EPIS (and sequencing)?

Interpretive response: Yes, if they are of the same class (i.e. with the same terms) and have been outstanding for the same period of time.

Example 4.4A.60

Determining EPIS

Consider the same fact pattern as presented in Example 4.4A.30. The following additional facts are relevant.

— The convertible bonds are classified as liabilities. During Year 1, the interest expense on the convertible bonds is $1,000. Upon conversion, 2,125 common shares would be issued.

— All expenses are tax-deductible. The applicable income tax rate is 21%.

Diluted EPS – EPIS calculation – Year 1

Step	Diluted EPS
1	**Identify potential common shares** The convertible bonds represent potential common shares.
2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:*

	Before tax	Related tax	After tax
Decrease in interest expense	$1,000	$(210) [$1,000 × 21%]	**$790**
Numerator adjustment			**$790**

Potential adjustment to the denominator for EPIS: 2,125 (see Example 4.4A.30).

EPIS = $790 ÷ 2,125 = $0.37

6.9A Options, warrants and forward sale contracts

Excerpt from ASC 260-10

• > Options, Warrants, and Their Equivalents and the Treasury Stock Method

45-22 The dilutive effect of outstanding call options and warrants (and their equivalents) issued by the reporting entity shall be reflected in diluted EPS by application of the treasury stock method unless the provisions of paragraphs 260-10-45-35 through 45-36 and 260-10-55-8 through 55-11 require that another method be applied. Equivalents of options and warrants include nonvested stock granted under a share-based payment arrangement, stock purchase contracts, and partially paid stock subscriptions (see paragraph 260-10-55-23). Antidilutive contracts, such as purchased put options and **purchased call options**, shall be excluded from diluted EPS.

45-23 Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. (See paragraphs 260-10-45-29 and 260-10-55-4 through 55-5.)
c. The incremental shares (the 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.

Example 15 (see paragraph 260-10-55-92) provides an illustration of this guidance.

45-25 Options and warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are in the money). Previously reported EPS data shall not be retroactively adjusted as a result of changes in market prices of common stock.

45-26 Dilutive options or warrants that are issued during a period or that expire or are cancelled during a period shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive options or warrants exercised during the period shall be included in the denominator for the period prior to actual exercise. The common shares issued upon exercise of options or warrants shall be included in the denominator for the period after the exercise date. Consequently, incremental shares assumed issued shall be weighted for the period the options or warrants were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

45-27 Paragraphs 260-10-55-3 through 55-11 provide additional guidance on the application of the treasury stock method.

• • > Options and Warrants and Their Equivalents

55-6 Options or warrants to purchase convertible securities shall be assumed to be exercised to purchase the **convertible security** whenever the average prices of both the convertible **security** and the common stock obtainable upon conversion are above the **exercise price** of the options or warrants. However, exercise shall not be assumed unless conversion of similar outstanding convertible securities, if any, also is assumed. The treasury stock method shall be applied to determine the incremental number of convertible securities that are assumed to be issued and immediately converted into common stock. Interest or dividends shall not be imputed for the incremental convertible securities because any imputed amount would be reversed by the if-converted adjustments for assumed conversions.

55-7 Paragraphs 260-10-55-9 through 55-11 provide guidance on how certain options, warrants, and convertible securities should be included in the computation of diluted EPS. Conversion or exercise of the potential common shares discussed in those paragraphs shall not be reflected in diluted EPS unless the effect is dilutive. Those potential common shares will have a dilutive effect if either of the following conditions is met:

a. The average market price of the related common stock for the period exceeds the exercise price.
b. The security to be tendered is selling at a price below that at which it may be tendered under the option or warrant agreement and the resulting discount is sufficient to establish an effective exercise price below the market price of the common stock obtainable upon exercise.

55-8 When several conversion alternatives exist, the computation shall give effect to the alternative that is most advantageous to the holder of the convertible security. Similar treatment shall be given to **preferred stock** that has similar provisions or to other securities that have conversion options that permit the investor to pay cash for a more favorable **conversion rate**.

55-9 Options or warrants may permit or require the tendering of debt or other securities of the issuer (or its parent or its **subsidiary**) in payment of all or a portion of the exercise price. In computing diluted EPS, those options or warrants shall be assumed to be exercised and the debt or other securities shall be assumed to be tendered. If tendering cash would be more advantageous to the option holder or warrant holder and the contract permits tendering cash, the treasury stock method shall be applied. Interest (net of tax) on any debt assumed to be tendered shall be added back as an adjustment to the numerator. The numerator also shall be adjusted for any nondiscretionary adjustments based on income (net of tax). The treasury stock method shall be applied for proceeds assumed to be received in cash.

55-10 The underlying terms of certain options or warrants may require that the proceeds received from the exercise of those securities be applied to retire debt or other securities of the issuer (or its parent or its subsidiary). In computing diluted EPS, those options or warrants shall be assumed to be exercised and the proceeds applied to purchase the debt at its average market price rather than to purchase common stock under the treasury stock method. The treasury stock method shall be applied, however, for excess proceeds received from the assumed exercise. Interest, net of tax, on any debt assumed to be purchased shall be added back as an adjustment to the numerator. The numerator also shall be adjusted for any nondiscretionary adjustments based on income (net of tax).

55-11 Convertible securities that permit or require the payment of cash by the holder of the security at conversion are considered the equivalent of warrants. In computing diluted EPS, the proceeds assumed to be received shall be assumed to be applied to purchase common stock under the treasury stock method and the convertible security shall be assumed to be converted under the **if-converted method**. See Example 11 (paragraph 260-10-55-78) for guidance on the effects of **contingently convertible instruments** on diluted EPS.

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45-23 Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. (See paragraphs 260-10-45-29 and 260-10-55-4 through 55-5.)
c. The incremental shares (the 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.

Example 15 (see paragraph 260-10-55-92) provides an illustration of this guidance. See paragraph 260-10-45-21A if the exercise price of a financial instrument or the number of shares that would be used to settle the financial instrument is variable.

55-7 Paragraphs 260-10-55-9 through 55-11 provide guidance on how certain options and warrants ~~options, warrants, and convertible securities~~ should be included in the computation of diluted EPS. ~~Conversion or exercise~~ Exercise of the potential common shares discussed in those paragraphs shall not be reflected in diluted EPS unless the effect is dilutive. Those potential common shares will have a dilutive effect if either of the following conditions is met:

a. The average market price of the related common stock for the period exceeds the exercise price.
b. The security to be tendered is selling at a price below that at which it may be tendered under the option or warrant agreement and the resulting discount is sufficient to establish an effective exercise price below the market price of the common stock obtainable upon exercise.

6.9A.10 Overview of the instruments

For EPS purposes, 'options, warrants and their equivalents' (collectively, 'options' in this section) are financial instruments that give holders the right to purchase common shares. Options in this section are generally written calls that give holders the right, but not the obligation, to acquire an entity's common shares with cash and/or by providing goods or services. If an entity receives goods or services in exchange for the options, the transaction generally falls in the scope of Topic 718; other options are generally in the scope of Topic 815 (derivatives).

Share-based payment awards and forward sale contracts are also discussed in this section. Forward sale contracts differ from options and warrants in that they are contracts that will always be settled. The exercise (or settlement) of options and warrants is generally at the discretion of the holder, and therefore not always settled.

In addition, the instruments discussed in this section are those that may require settlement in common shares. An option that is always settled net in cash does not entitle its holder to common shares and therefore is ignored in the diluted EPS denominator because it is not a potential common share.

This section covers the EPS implications for options in general. Some instruments may require additional consideration, and are discussed in the following sections:

- written put options and forward purchase contracts, see section 6.15;
- purchased puts and calls, see section 6.16;
- options embedded in other financial instruments, see section 6.11;
- options subject to performance or market conditions other than service conditions, see section 6.10;
- options to purchase convertible instruments, see section 6.12A; and
- instruments that may be settled in cash or shares, see section 6.13A.

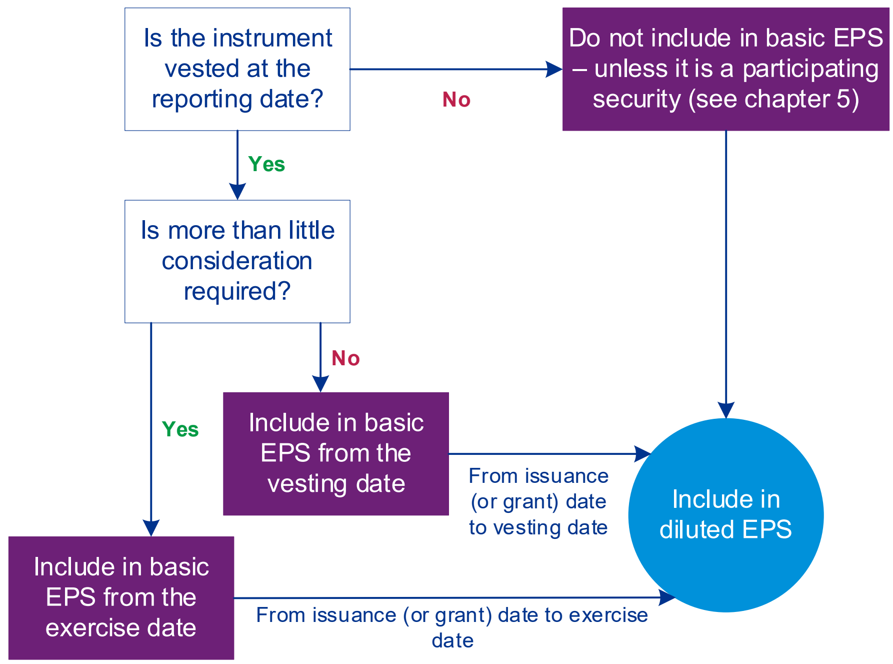
Additional considerations in the context of share-based payment awards are discussed in section 6.9A.40 and chapter 5.

The EPS implications for an equity-linked financial instrument with a down-round feature are discussed in section 6.18A.

6.9A.20 EPS implications

Unless they are participating securities or are issuable for little or no consideration, options affect only diluted EPS.

Understanding the accounting for these options is relevant because it determines whether their assumed exercise would have a consequential effect on earnings. This is illustrated in the following decision tree.



Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X **Denominator X / ✓**	**Numerator X / ✓** **Denominator X / ✓**
Options are generally ignored in basic EPS because they are not common shares. However, options exercisable for little consideration are included in the denominator from the vesting date (see section 3.4.30). [260-10-45-13] Forward sale contracts are ignored in basic EPS. However, if they are prepaid, the minimum amount of shares to be issued is included in basic EPS. See Question 6.15.30. Options and forward contracts that are participating securities are included in basic EPS using the two-class method. See chapter 5.	Options are potential common shares. These instruments are assumed exercised and included in diluted EPS if they are in-the-money (i.e. the average market price of the related common shares for the period exceeds the exercise price). When determining if share-based payment awards are in-the-money, the average market price is compared to the overall proceeds per share, which includes the unearned compensation (see section 6.9A.40). [260-10-55-7] The potential adjustment to the numerator depends on whether the options are accounted for under Topic 505 (equity), Topic 718 (share-based payments) or Topic 815 (derivatives and hedging), and their manner of settlement. If an instrument is classified as an asset or liability and measured at fair value, and share settlement is required or presumed, the fair value (i.e. mark-to-market) amount is a numerator adjustment for EPS purposes. Section 6.13A discusses contracts that may be settled in shares or cash.

<table>
<tr><th>Potential effect on basic EPS</th><th>Potential effect on diluted EPS</th></tr>
<tr><td></td><td>
The following table assumes share settlement.[1]
<table>
<tr><th>Accounting for options</th><th>Potential numerator adjustment?</th></tr>
<tr><td>Equity</td><td>No</td></tr>
<tr><td>Liability</td><td>Yes</td></tr>
</table>
For instruments that may be settled in cash or shares, see section 6.13A.
For instruments with variable exercise prices, see section 4.4A.40.
The potential adjustment to the denominator is determined using the treasury stock method. The potential shares are included only for the period in which they were outstanding – i.e. from the beginning of the period, or from the date on which the options are issued or granted if this is later. Also, options are not included for the period after which they are exercised (because they are already included in basic EPS) or forfeited. [260-10-45-26]
The denominator in the year-to-date period is calculated using an average of the quarterly denominators, as discussed in section 8.3.30.
Participating securities are included in diluted EPS using the more dilutive of the two-class method or the treasury stock method. See section 5.7.
</td></tr>
<tr><td colspan="2">
Dilutive or antidilutive?
Generally, options are dilutive if they are in-the-money – i.e. the total proceeds per share (including the fair value of any goods or services to be supplied to the entity in the future, and unearned compensation for share-based payment awards) is lower than the average market price of the common shares. However, for options that are accounted for as liabilities under Topic 718 or Topic 480, the numerator adjustment could vary and could therefore affect whether the options are dilutive. [260-10-45-25, 55-36A]
Forward sale contracts may be dilutive even if they are out-of-the-money from the counterparty's perspective – i.e. the price at the end of the reporting period is less than the contract price. This is because the treasury stock method uses the average market price during the period and not the price at the end of the reporting period to determine if there are incremental shares to be added to the denominator. Also, numerator adjustments could affect whether a forward is dilutive.
</td></tr>
</table>

6.9A.30 Denominator adjustment for options – the treasury stock method

Generally, the denominator for diluted EPS assumes that all dilutive potential common shares have been converted into common shares at the beginning of the period; or the date of issue of the potential common shares, if later. In addition, they are included in the denominator only for the period during which they are outstanding (see section 4.4A.40).

In the context of freestanding options, instead of simply adding to the denominator the weighted-average number of common shares that would be issued from the assumed conversion of options, Topic 260 prescribes a specific method to determine the number of shares to add to the denominator. This method is commonly referred to as the 'treasury stock method' and is different from the method prescribed for options that are embedded in other financial instruments – e.g. convertible debt (see section 6.12A). [260-10-45-22 – 45-23, 45-26]

The treasury stock method assumes the entity uses the proceeds it receives when the options are exercised (which are based on the exercise price) to repurchase shares at the average market price of a common share during the period. The difference between the number of common shares that would be issued at the exercise price and the number of common shares that would be repurchased at the average market price is referred to as the incremental shares. Only the incremental shares to be issued (i.e. the number calculated under Step (iii) below) are reflected in diluted EPS. The following diagram summarizes the treasury stock method. [260-10-45-23]

The treasury stock method		
Step i	**Calculate the assumed proceeds** Calculate the proceeds that would have been received from the assumed exercise of all options.	'Exercise price' x number of options
Step ii	**Calculate the number of common shares deemed to be repurchased at average market price** Calculate the number of common shares that would have been repurchased if the proceeds received in Step (i) were used to acquire these shares at their average market price during the period.	Assumed proceeds ÷ average market price of shares
Step iii	**Determine the incremental shares** Calculate the difference between the number of common shares that would be issued at the exercise of the options and the number of common shares deemed to be repurchased at the average market price.	Number of shares that would be issued – number of shares deemed to be repurchased

The treasury stock method is discussed in further detail in section 4.4A.40.

Applying the treasury stock method when an option's exercise price is settled wholly or partially in other instruments

Some options may permit or require an entity to tender a debt or another instrument issued by it or its subsidiary in payment of all or a portion of the exercise price of the option.

These options may be dilutive if: [260-10-55-7]

- the average market price of the common shares for the period exceeds the exercise price; or
- the selling price of the instrument to be tendered is below that at which the instrument may be tendered under the option and the resulting discount establishes an effective exercise price that is below the market price of the common shares obtainable on exercise.

The exercise of the options and the tendering of the instruments are assumed for diluted EPS, and included in diluted EPS if dilutive. After-tax interest on any debt assumed to be tendered and any nondiscretionary income adjustments are added to the numerator (see section 4.4A.30). [260-10-55-9]

However, if the option may be settled in cash, the cash alternative is assumed if it is more advantageous to the holder of the instrument. For example, the holder may have a more favorable conversion price if paid in cash. How EPS is calculated in both instances is discussed in Questions 6.9A.20 and 6.12A.50. [260-10-55-9]

Question 6.9A.20

How is EPS affected by options when their exercise price is settled or partially settled in other instruments?

Interpretive response: While Topic 260 discusses the adjustment to the numerator of diluted EPS for such options, it does not specify how to apply the treasury stock method to calculate the effect of such options on the denominator. We believe one acceptable approach is to use a similar approach to that for convertible instruments – i.e. the if-converted method (see section 4.4A.20) instead of the treasury stock method. This means that, for the portion for which the exercise price may be paid up by tendering debt or other instruments, the denominator should be adjusted for the total number of shares assumed to be issued. For the portion for which the exercise will be paid in cash, the treasury stock method is used.

Question 6.9A.30

How is diluted EPS affected when the terms of an option require the exercise proceeds to be used to redeem debt or other instruments?

Interpretive response: In some cases, the terms of options require the proceeds received from exercise to be used to redeem debt or other instruments of the entity (or its parent or a subsidiary). In determining diluted EPS, it is assumed that the proceeds are used first to purchase these other instruments at their average market price. The numerator is adjusted by the after-tax interest savings on the assumed redemption and any nondiscretionary income adjustments (net of tax) (see section 4.4A.40). If the proceeds to be received exceed the redemption amount, the excess is assumed to be used to purchase common shares under the treasury stock method. [260-10-55-10]

The EPS calculations for these types of options are illustrated in Example 6.9A.20.

Question 6.9A.40

How is EPS affected by options to purchase convertible instruments?

Interpretive response: Options or warrants to purchase convertible instruments (e.g. an option to purchase convertible preferred shares) may also be considered potential common shares. In many cases, these options do not meet the requirements for classification as equity instruments under Topic 505 and are accounted for as derivatives under Topic 815.

In such cases, the options are assumed to be exercised to purchase the convertible instrument and the convertible instrument is deemed to be converted into common shares when calculating diluted EPS only if: [260-10-55-6]

- the average price of the convertible instrument is above the exercise price of the option;
- the average price of the common shares obtainable on conversion is above the exercise price of the option; and
- the conversion of similar outstanding convertible instruments (if any) is also assumed.

Also, there may be a numerator adjustment to reverse the effect of fair value adjustments when marking the instrument to market because the instrument is deemed converted into common shares. This adjustment may affect whether an option is dilutive (see section 4.4A).

To calculate the effect of these instruments on diluted EPS, because they are options, the treasury stock method is used in determining the effect on the denominator, assuming the option holders would exercise the options and then immediately convert the instrument received from the exercise to obtain common shares (see section 6.9A). The after-tax consequential changes in income or expense are adjusted in the numerator, using the if-converted method (see section 4.4A.20). Interest or dividends on the incremental convertible securities are not imputed because these would just be reversed when applying the if-converted method. [260-10-55-6]

If there are multiple exercise or conversion alternatives, an entity applies the guidance in Topic 260 on multiple conversion bases (see section 4.4A.40).

The EPS calculations for options to purchase convertible instruments are illustrated in Example 6.9A.30.

Question 6.9A.50

How is EPS affected by a reduction in the exercise price of warrants to induce their exercise?

Interpretive response: As discussed in Question 3.3A.90, we believe an inducement to exercise warrants is like a cost of raising additional capital, and not like a preferential return discussed in paragraph 260-10-S99-2 (as is the case for an induced conversion of preferred shares).

Therefore, the reduction in exercise price of the warrants:

- results in a reduction in equity on exercise of the warrant (by receipt of a lower exercise price);
- has no effect on the numerator of EPS; and
- increases the dilutive effect of the warrant in the treasury stock method calculation.

Question 6.9A.55

How is the treasury stock method applied when there is a cashless exercise (i.e. net share settlement) provision that may be elected to cover the exercise price?

Background: Cashless exercise (i.e. net-share settlement) upon settlement permits the holder of the instrument to pay the exercise price and tax withholdings (if applicable) in shares, and receive the net amount of shares, after deducting those used for the exercise price and tax withholdings. A cashless exercise is similar to two transactions occurring simultaneously: gross settlement of the instrument and an immediate repurchase from the holder of the issued shares in an amount that covers the cost of the exercise price and tax withholdings.

Interpretive response: When net-share settlement is optional (an election), the treasury stock method is applied in the normal manner, assuming gross settlement and using the average market price of the shares in the calculation. The repurchase of shares for the exercise or forward price (net-share settlement feature) is ignored. This is done in keeping with the principles of using an average market price in the treasury stock method, even though net-share settlement, if elected, may be based on the current market price of the shares.

However, when net-share settlement is required (not an election), the net shares to be issued are instead considered contingently issuable shares and the amount of shares to be included in diluted EPS is calculated based on the terms of the contract (e.g. current market price).

6.9A.40 Interpretive analysis and examples

Example 6.9A.10
Options settled gross in shares

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

ABC has the following equity-classified stock options issued to investors (third parties).

Terms	Option A	Option B	Option C
Total number of options	200,000	1,250,000	500,000
Issuance (and vesting) date	Before January 1, Year 1	Before January 1, Year 1	July 1, Year 1
Options exercised	–	500,000 on December 31	–
Exercise price per option	(no consideration)	$10	$20

Each option is exercisable for one common share, and the options do not entitle the holders to dividends before they are exercised.

The following information is also relevant.

- The average market prices of ABC's common shares are:
  - Year-end December 31: $15
  - Six months ended December 31 (for Option C): $16
- Net income for Year 1 is $4,600,000.

ABC reports only on an annual basis (i.e. does not prepare interim financial statements).

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** Although the options under Option A have not been converted into common shares during the year, they have been included in basic EPS throughout the period because they can be exercised for no further consideration and they were vested for the full period. Therefore, they are not potential common shares throughout the year. Unlike the options under Option A, those under Options B and C are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.
2	**Determine the denominator** Because the options under Option A are vested and exercisable for little or no further consideration, they are included in the denominator from the vesting date – i.e. included throughout the year. The options under Options B and C are ignored in basic EPS until they are actually exercised, because the exercise price is more than little consideration. ABC calculates the denominator as follows.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the options are classified as equity (see section 6.9A.20). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step	Basic EPS			
		Number of shares	**Time weight.**	**Weighted average**
	Common shares outstanding	3,000,000		
	Vested share options exercisable for no consideration	200,000		
	Jan. – Dec.	3,200,000	12/12	3,200,000
	Dec. 31: share options exercised	500,000		
	Dec. 31	3,700,000	0/12	0
			12/12	
	Weighted average for the year			**3,200,000**

Step	Diluted EPS			
		Option B	**Option C**	
Step i	Weighted-average number of options (and shares to be issued on exercise of the options)[1]	1,250,000	250,000	(A)
	Exercise price	$10.00	$20.00	(B)
	Assumed proceeds	$12,500,000	$5,000,000	(C) = (A) × (B)
Step ii	Average market price of common shares	$15.00	$16.00	(C)
	Number of common shares deemed repurchased	833,333	312,500	(E) = (C) ÷ (D)
Step iii	**Incremental shares**[2]	416,667	–	(A) – (E)

Step	Basic EPS	Step	Diluted EPS
	Therefore, the denominator is 3,200,000.		Notes: 1. In this step, the weighted-average number of options under Option B reflects the exercise of 500,000 options on December 31: (1,250,000 × 12) + (500,000 × 0) ÷ 12 = 1,250,000. The weighted-average number of options under Option C reflects the fact that the options were issued on July 1: 500,000 × 6 ÷ 12 = 250,000. 2. The options under Option C are antidilutive and therefore are ignored in the denominator; this is because the exercise price is higher than the average market price for the period during which these options are outstanding.
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,200,000 = $1.44	3	**Rank the potential common shares** This step does not apply. Because the options under Option C are antidilutive, the options under Option B are the only class of potential common shares considered.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.44 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The options under Option B are dilutive because no adjustment to the numerator for EPIS is required and the exercise price is lower than the average market price of a common share during the period.

	Earnings	Weighted -avg. no. of shares	Per share	Dilutive ?
Basic EPS	$4,600,000	3,200,000	$1.44	
Incremental shares in Option B		416,667		

Step	Basic EPS	Step	Diluted EPS				
			Total	**$4,600,000**	**3,616,667**	$1.27	✓
			Therefore, ABC includes the effect of the Option B options in diluted EPS. Diluted EPS = $1.27				

Example 6.9A.15
Options with variable exercise price

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issued 1,250,000 stock options to investors in connection with a private placement offering. The exercise price varies as follows.

If exercised by:	Then exercise price is:
January 1, Year 2	$20
January 1, Year 3	$18
January 1, Year 4	$15
January 1, Year 5	$10

The following information is also relevant.

- Each option is exercisable for one common share, and the options do not entitle the holders to dividends before they are exercised.
- The average market price of ABC's common shares during the year was $15.
- Net income for Year 1 is $4,600,000.

ABC reports only on an annual basis (i.e. does not prepare interim financial statements).

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** Options are exercisable for more than a little consideration and are therefore potential common shares for the period during which they are outstanding.
2	**Determine the denominator** No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than a little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the options are classified as equity (see section 6.9A.20). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows. Because the exercise price varies only with time, the entity uses the most advantageous price available to the holder at any point in time (see section 4.4A.40). In this case, it is $10. [260-10-45-21]

Step i	Weighted-average number of options (and shares to be issued on exercise of the options)	1,250,000	(A)
	Exercise price	$10.00	(B)
	Assumed proceeds	$12,500,000	(C) = (A) × (B)
Step ii	Average market price of common shares	$15.00	(C)
	Number of common shares deemed repurchased	833,333	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	416,667	(A) – (E)

Because there is no numerator adjustment, EPIS is 0.

Step	Basic EPS
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Step	Diluted EPS
3	**Rank the potential common shares** This step does not apply because the options are the only class of potential common shares outstanding.
4	**Determine basic EPS from continuing operations** Basic EPS is $1.53 (see Step 3 of basic EPS calculation).
5	**Identify dilutive potential common shares and determine diluted EPS** The options are dilutive because no adjustment to the numerator for EPIS is required and the exercise price is lower than the average market price of a common share during the period.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares in Option B		416,667		
Total	**$4,600,000**	**3,416,667**	$1.35	✓

Therefore, ABC includes the effect of the options in diluted EPS.

Diluted EPS = $1.35

Example 6.9A.20

Proceeds used to redeem debt or other instruments of the entity

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 200,000 equity-settled share options. Each option may be exercised to purchase one common share for $100.

The holders of these options also own 60,000 bonds issued by ABC. The terms of the options require ABC to use the exercise proceeds to repurchase these bonds.

- The average market price of ABC's common shares during Year 1 is $95, and the average market price of each bond during Year 1 is $90.
- Net income for Year 1 is $4,600,000, which includes interest expense of $250,000 on the bonds. The interest expense is tax deductible, and the applicable income tax rate is 21%.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** Options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.
2	**Determine the denominator** No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** It is assumed that the proceeds from the exercise price would be used to repurchase the bonds. Therefore, $5,400,000 [60,000 × $90] of the total proceeds of $20,000,000 [200,000 × $100] is not considered as assumed proceeds in applying the treasury stock method. *Potential adjustment to the numerator for EPIS:* The redemption of the bonds would increase income for the year by the post-tax amount of the interest expense: (interest expense on the bonds) × (1 – income tax rate) = ($250,000) × (1 – 21%) = $197,500

<table>
<tr><th>Step</th><th>Basic EPS</th><th>Step</th><th>Diluted EPS</th></tr>
<tr><td></td><td></td><td></td><td>Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method, as follows. Only the proceeds exceeding the assumed repurchase of the bonds are used.
<table>
<tr><td rowspan="4">Step i</td><td>Number of options (and shares to be issued on exercise of options)</td><td>200,000</td><td>(A)</td></tr>
<tr><td>Exercise price</td><td>$100</td><td>(B)</td></tr>
<tr><td>Proceeds used to redeem outstanding bonds</td><td>(5,400,000)</td><td>(C)</td></tr>
<tr><td>Assumed proceeds</td><td>14,600,000</td><td>(D) = ((A) × (B)) – (C)</td></tr>
<tr><td rowspan="2">Step ii</td><td>Average market price of common shares</td><td>$95.00</td><td>(E)</td></tr>
<tr><td>Number of common shares deemed repurchased</td><td>153,684</td><td>(F) = (D) ÷ (E)</td></tr>
<tr><td>Step iii</td><td>Incremental shares</td><td>46,316</td><td>(A) – (F)</td></tr>
</table>
EPIS is therefore $197,500 ÷ 46,316 = $4.26</td></tr>
<tr><td>3</td><td>Determine basic EPS
Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53</td><td>3</td><td>Rank the potential common shares
This step does not apply, because the options are the only class of potential common shares considered.</td></tr>
<tr><td></td><td></td><td>4</td><td>Determine basic EPS from continuing operations
Basic EPS is $1.53 (see Step 3 of basic EPS calculation).</td></tr>
</table>

Step	Basic EPS	Step	Diluted EPS
		5	**Identify dilutive potential common shares and determine diluted EPS**

The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Options exercised by tendering notes	197,500	46,316		
Total	**$4,797,500**	**3,046,316**	$1.57	✗

To the extent that the options are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

Diluted EPS = $1.53

Example 6.9A.25

Options exercised by tendering other instruments of the entity

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 200,000 equity-settled share options. Each option may be exercised to purchase one common share for $100.

The holders of these options also own 60,000 bonds issued by ABC. The terms of the options permit the holder to tender the bonds in lieu of cash when exercising the options.

— The average market price of ABC's common shares during Year 1 is $95, and the par value of each bond is $90. The bonds are trading at par.

— Net income for Year 1 is $4,600,000, which includes interest expense of $250,000 on the bonds. The interest expense is tax deductible and the applicable income tax rate is 21%.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** Options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.
2	**Determine the denominator** No adjustment is necessary until the options are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** It is assumed that bonds will be tendered to partially satisfy the exercise price (because there is no advantage to tendering cash). Therefore, $5,400,000 [60,000 × $90] of the total proceeds of $20,000,000 [200,000 × $100] is not considered as assumed proceeds in applying the treasury stock method. *Potential adjustment to the numerator for EPIS:* Tendering of the bonds would increase income for the year by the post-tax amount of the interest expense: (interest expense on the bonds) × (1 – income tax rate) = ($250,000) × (1 – 21%) = $197,500 *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows. Only the proceeds exceeding the tendered value of the bonds are used.

Step	Basic EPS	Step	Diluted EPS

Step i	Number of options (and shares to be issued on exercise of options)	200,000	(A)
	Exercise price	$100	(B)
	Bond value tendered	($5,400,000)	(C)
	Assumed proceeds	$14,600,000	(D) = ((A) × (B)) – (C)
Step ii	Average market price of common shares	$95.00	(E)
	Number of common shares deemed repurchased	153,684	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	46,316	(A) – (F)

EPIS is therefore $197,500 ÷ 46,316 = $4.26

Basic EPS — Step 3

Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53

Diluted EPS — Step 3

Rank the potential common shares

This step does not apply, because the options are the only class of potential common shares considered.

Diluted EPS — Step 4

Determine basic EPS from continuing operations

Basic EPS is $1.53 (see Step 3 of basic EPS calculation).

Step	Basic EPS	Step	Diluted EPS
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Options exercised by tendering bonds	197,500	46,316		
Total	**$4,797,500**	**3,046,316**	$1.57	✗

To the extent that the options are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

Diluted EPS = $1.53

Observation

Options exercised by tendering other instruments of the entity

As seen in Example 6.9A.25, when a holder of a convertible instrument has all of the following, the calculation (and result) is the same as if the holder were *required* to tender the instrument (see Example 6.9A.20):

- the option to tender either the instrument or cash upon exercise;
- it is assumed that the holder will tender the instrument; and
- the fair value of the instrument equals its par value.

Example 6.9A.30
Options over convertible preferred shares

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 500,000 options over convertible noncumulative nonparticipating preferred shares.

- Each option is to acquire one convertible preferred share at an exercise price of $50. Each preferred share is convertible into two common shares.
- The options are classified as derivatives. The expense for remeasurement of the options at fair value is $100,000 for the year. The remeasurement expense is tax-deductible, and the applicable income tax rate is 21%.
- There are no other similar convertible preferred shares outstanding.

The following average prices are also relevant for the period:

- market price of convertible preferred shares: $65
- market price of ABC's common shares: $30.

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary until the options are exercised and convertible instruments are converted and common shares are issued. The numerator is $4,600,000.	1	**Identify potential common shares** The options over convertible preferred shares are the only potential common shares.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** — The exercise price per convertible preferred share [$50] is lower than its average market price [$65]. — The exercise price per common share on conversion [$50 × 500,000 ÷ 1,000,000 = $25] is lower than its average market price [$30]. — There is no similar outstanding convertible instrument.

Step	Basic EPS	Step	Diluted EPS
			Therefore, the exercise of the options is assumed because they are in-the-money. *Potential adjustment to the numerator for EPIS:* The options, if exercised, would increase income for the year by the after-tax amount of the remeasurement expense: (remeasurement expense on the options) × (1 – income tax rate) = ($100,000) × (1 – 21%) = $79,000 *Potential adjustment to the denominator for EPIS:* Calculate the effect using the treasury stock method as follows.

Step i	Number of options	500,000	(A)
	Exercise price	$50.00	(B)
	Assumed proceeds	$25,000,000	(C) = (A) × (B)
Step ii	Average market price of common shares	$30.00	(D)
	Number of common shares deemed repurchased	833,333	(E) = (C) ÷ (D)
Step iii	Common shares to be issued per option	2[1]	(F)
	Common shares to be issued on conversion	1,000,000	(G) = (F) × (A)
	Incremental shares	166,667	(G) – (E)

Note:

1. Each option is exercisable into one convertible noncumulative preferred share, which, in turn, is convertible into two common shares.

EPIS is therefore $79,000 ÷ 166,667 = $0.47

Step	Basic EPS	Step	Diluted EPS
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53	3	**Rank the potential common shares** This step does not apply because the options over the convertible preferred shares are the only class of potential common shares considered.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.53 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of options over convertible preferred shares is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares from options over convertible preferred shares	79,000	166,667		
Total	**$4,679,000**	**3,166,667**	$1.48	✓

Therefore, ABC includes the options over convertible preferred shares in diluted EPS.

Diluted EPS = $1.48

Example 6.9A.32
Liability-classified warrants exercised during the year

ABC Corp. has 3,000,000 weighted-average common shares outstanding and net income of $4,600,000 during Year 1.

On January 1, Year 1, ABC issues warrants to buy 600,000 common shares at $11.50 per share.

- The warrants are classified as a liability under Subtopic 815-40.
- The warrants are required to be settled in shares.
- The warrants contingently participate in distributions, but none of the contingencies were met during Year 1.
- The warrants were fully exercised on September 1, Year 1.

The following information is also relevant.

- ABC records expense of $1,200,000 (after-tax) during the year due to changes in the fair value of the warrants.
- The average market price of ABC's common shares during Year 1 is $17/share.
- The warrant holders are not entitled to dividends.

EPS calculations –Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** The warrants are potential common shares for the period during which they are outstanding (i.e. before they were exercised).
2	**Determine the denominator** The warrants are ignored in basic EPS until they are actually exercised. ABC calculates the denominator as follows.	2	**For each potential common share, calculate EPIS** The contract is settleable in common shares, and therefore the effect of the liability classification is reversed as a numerator adjustment. *Potential adjustment to the numerator for EPIS:* The exercise of the warrants would increase income for the year by the fair value adjustment (after-tax) of $1,200,000. *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step	Basic EPS

	Number of shares	Time weight.	Weighted average
Jan.- Aug.	3,000,000		
	3,000,000	8/12	2,000,000
Sept. 1: warrants exercised	600,000		
Dec. 31	3,600,000	4/12	1,200,000
		12/12	
Weighted average for the year			**3,200,000**

Therefore, the denominator is 3,200,000.

3 **Determine basic EPS**

Basic EPS = $4,600,000 ÷ 3,200,000 = $1.44

Step	Diluted EPS

Step i	Weighted-average number of warrants (and shares to be issued on exercise of the warrants)[1]	400,000	(A)
	Exercise price	$11.50	(B)
Step ii	**Assumed proceeds**	$4,600,000	(C) = (A) × (B)
	Average market price of common shares	$17.00	(D)
	Number of common shares deemed repurchased	270,588	(E) = (C) ÷ (D)
Step iii	**Incremental shares**[2]	129,412	(A) – (E)

Notes:

1. In this step, the weighted-average number of warrants reflects the exercise of 600,000 options on September 1: (600,000 × 8) + (0 × 4) ÷ 12 = 400,000.
2. [400,000 – 270,588]

3 **Rank the potential common shares**

This step does not apply. The warrants are the only class of potential common shares.

4 **Determine basic EPS from continuing operations**

Basic EPS is $1.44 (see Step 3 of basic EPS calculation).

Step	Basic EPS	Step	Diluted EPS
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of the warrants is as follows.

	Earnings	Weighted -avg. no. of shares	Per share	Dilutive ?
Basic EPS	$4,600,000	3,200,000	$1.44	
Warrants	1,200,000	129,412		
Total	**$5,800,000**	**3,329,412**	$1.74	✗

The warrants are antidilutive because they increase EPS.

Therefore, diluted EPS is the same as basic EPS = $1.44

Question 6.9A.60

How is diluted EPS calculated when parent options will be exchanged for subsidiary options in connection with a spinoff or carve-out?

Interpretive response: In calculating diluted EPS for a spinoff or carve-out, if parent options will be exchanged for subsidiary options as part of the initial capitalization of the entity, the exchanged options should generally be treated as subsidiary options in historical calculations of diluted EPS. However, we believe if options are later exchanged, the exchange should be included in diluted EPS only prospectively from the date it occurs.

Example 15 in Topic 260 (reproduced below) also illustrates the treatment for options, warrants and their equivalents.

Excerpt from ASC 260-10

• > Example 15: Options, Warrants, and Their Equivalents

55-92 This Example illustrates the guidance in paragraphs 260-10-45-22 through 45-23.

55-93 Consider Entity A that has 10,000 warrants outstanding exercisable at $54 per share; the average market price of the common stock during the reporting period is $60. Exercise of the warrants and issuance of 10,000 shares of common stock would be assumed. The $540,000 that would be realized from exercise of the warrants ($54 × 10,000) would be an amount sufficient to acquire 9,000 shares ($540,000/$60). Thus, 1,000 incremental shares (10,000 – 9,000) would be added to the outstanding common shares in computing diluted EPS for the period.

55-94 The following is a shortcut formula for that computation (note that this formula may not be appropriate for stock-based compensation awards [see paragraph 260-10-45-29]):

Incremental shares = [(market price – exercise price)/market price] × shares assumed issued under option; thus, [($60 – $54)/$60] ×10,000 = 1,000 incremental shares.

6.9A.50 Share-based payment awards

Excerpt from ASC 260-10

• • > Share-Based Payment Arrangements

45-28 The provisions in paragraphs 260-10-45-28A through 45-31 apply to share-based awards issued to grantees under a share-based payment arrangement in exchange for goods and services.

45-28A Awards of share **options** and nonvested shares (as defined in Topic 718) to be issued to a grantee under a share-based compensation arrangement are considered options for purposes of computing diluted EPS. Such share-based awards shall be considered to be outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent upon vesting. Those share-based awards are included in the diluted EPS computation even if the grantee may not receive (or be able to sell) the stock until some future date. Accordingly, all shares to be issued shall be included in computing diluted EPS if the effect is dilutive. The dilutive effect of share-based payment arrangements shall be computed using the **treasury stock method**. If the equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding. See Example 8 (paragraph 260-10-55-68).

45-29 In applying the treasury stock method described in paragraph 260-10-45-23, the assumed proceeds shall be the sum of both of the following:

a. The amount, if any, the grantee must pay upon exercise.
b. The amount of cost attributed to share-based payment awards (within the scope of Topic 718 on stock compensation) not yet recognized. This amount includes share-based payment awards that are not contingent upon satisfying certain conditions as described in paragraph 260-10-45-32 and contingently issuable shares that have been determined to be included in the computation of diluted EPS as described in paragraphs 260-10-45-48 through 45-57
c. [Subparagraph superseded by Accounting Standards Update No. 2016-09].

45-29A Under paragraphs 718-10-35-1D and 718-10-35-3, the effect of forfeitures is taken into account by recognizing compensation cost for those instruments for which the employee’s requisite service has been rendered or the nonemployee’s vesting conditions have been met and no compensation cost shall be recognized for instruments that grantees forfeit because a service or performance condition is not satisfied. See Example 8 (paragraph 260-10-55-68) for an illustration of this guidance.

45-30 If stock-based payment arrangements are payable in common stock or in cash at the election of either the entity or the grantee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 260-10-45-45. If an entity has a tandem award (as defined in Topic 718) that allows the entity or the grantee to make an election involving two or more types of equity instruments, diluted EPS for the period shall be computed based on the terms used in the computation of compensation cost for that period.

45-31 Awards with a market condition, a performance condition, or any combination thereof (as defined in Topic 718) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 260-10-45-48 through 45-57.

45-32 Fixed grantee stock options (fixed awards) and nonvested stock (including restricted stock) shall be included in the computation of diluted EPS based on the provisions for options and warrants in paragraphs 260-10-45-22 through 45-27. Even though their issuance may be contingent upon vesting, they shall not be considered to be contingently issuable shares (see Section 815-15-55 and paragraph 260-10-45-48). However, because issuance of performance-based stock options (and performance-based nonvested stock) is contingent upon satisfying conditions in addition to the mere passage of time, those options and nonvested stock shall be considered to be contingently issuable shares in the computation of diluted EPS. A distinction shall be made only between time-related contingencies and contingencies requiring specific achievement.

In general, the EPS treatment of share-based payment awards is based on the guidance in Topic 260 for the relevant instrument – e.g. options, contingent shares. Unvested shares are treated similarly to options for purposes of calculating diluted EPS. [260-10-45-28 – 45-28A]

Share-based payment awards that must be settled in cash and will never result in the issuance of common shares, are excluded from EPS calculations. Awards that may be settled in cash or shares are included in EPS following the guidance for those instruments in section 6.13A.

Basic EPS

Unvested share-based payment awards generally do not affect basic EPS unless they are participating securities – in which case, the two-class method is used (see chapter 5). Vested awards may affect basic EPS depending on the type of instrument.

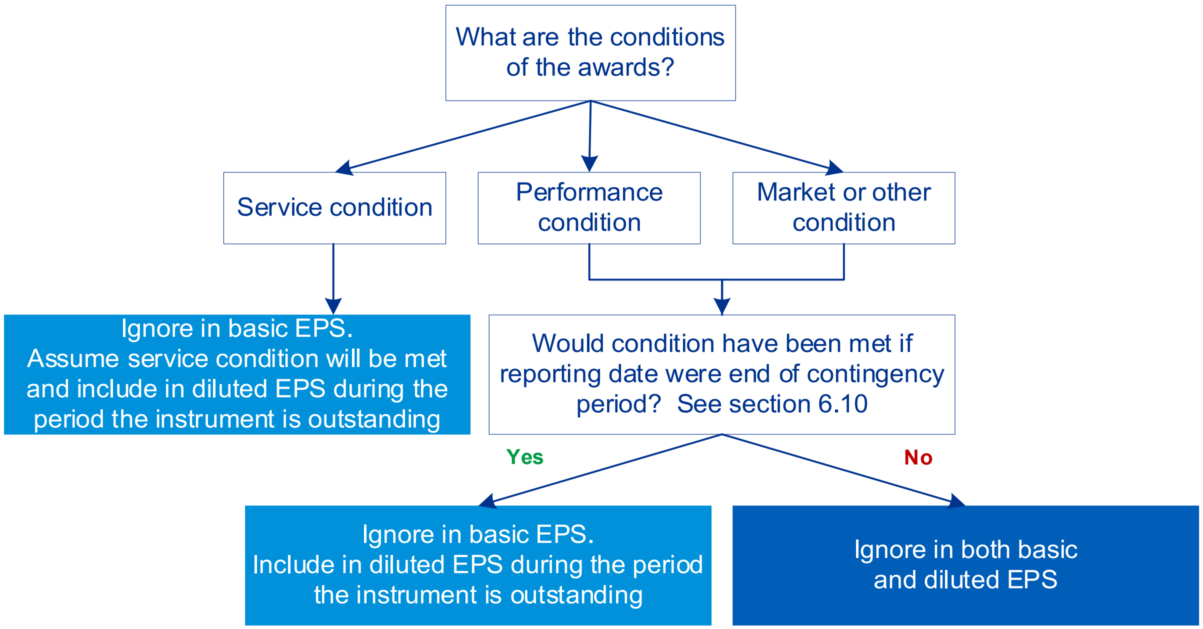
- Stock awards (unvested stock, RSUs) are considered outstanding common shares and included in basic EPS from the date the awards are vested and services are received or goods are delivered. This is consistent with the treatment of contingently issuable shares (see section 6.10.20), whereby the shares are included when there are no circumstances, other than the passage of time, under which they would not be issued. [260-10-45-12C – 45-13]
- Options or warrants are generally not considered outstanding common shares until exercised, even if they are vested. See the discussion in sections 6.8 (unvested common shares) and 6.9A.20 (options and warrants).

Diluted EPS

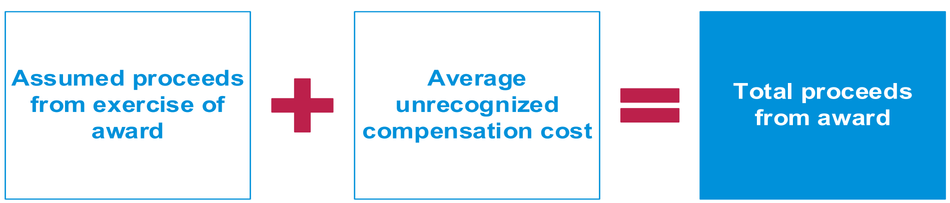
Share-based payment awards that are not included in basic EPS (or if included in basic EPS, for periods before they are included) are considered for diluted EPS even if they are not vested or cannot be exercised, if they are in the money (see section 6.9A.20). Generally, share-based payment awards whose vesting is contingent only on future service (service condition) are included in diluted EPS assuming the service condition will be met. Share-based payment awards with performance or market conditions are evaluated under the contingency guidance discussed in sections 6.10 and 6.11. See also examples 6.10.10 and 6.10.11. Estimated forfeitures are ignored in diluted EPS (see Question 6.9A.70). [260-10-45-28A, 45-29A]

The following diagram highlights the EPS considerations for evaluating the various conditions in share-based payment awards.

See section 6.10 for examples of EPS for share-based payment awards with performance and market conditions.



A modified treasury stock method applies to share-based payment awards with a service condition. Under the modified method, the assumed proceeds from exercise of the award includes the average unrecognized compensation cost during the period on the share options. Therefore, the assumed proceeds are calculated as: [260-10-45-29]



The compensation cost is the grant-date fair value of the award calculated under Topic 718. The average unrecognized compensation cost relates to the period for which the instrument is outstanding, and is calculated as:

$$\frac{\left(\text{Unrecognized compensation cost at beginning of period}^{1} + \text{Unrecognized compensation cost at end of period}^{1}\right)}{2} = \text{Average unrecognized compensation cost}$$

Note:

1. Assumes compensation is recognized ratably, although attribution might not be ratable.

For instruments with no exercise price (unvested stock, RSUs) the proceeds are comprised solely of unrecognized compensation costs.

The treasury stock method is discussed in section 6.9A.30.

Example 6.9A.35
EPS for share-based payment awards

ABC Corp. has 1,500,000 shares outstanding at January 1, Year 1. ABC institutes its first share option plan in Year 1.

On January 1, Year 1, ABC grants 100,000 stock options with an exercise price equal to the market price of the share at that date ($30). The fair value of each stock option granted is $9 and the options cliff vest at the end of three years.

ABC calculates compensation cost of $900,000 (100,000 × $9) at grant date, to be recognized ratably at $300,000 per year under Topic 718.

The following information is also relevant.

- Net income for Year 1 is $2,500,000.
- ABC's accounting policy is to account for forfeitures when they occur. There were no forfeitures during Year 1.
- The average market price of ABC's shares during Year 1 is $42.
- ABC's tax rate is 21%.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary until the options are exercised and convertible instruments are converted and common shares are issued. The numerator is $2,500,000.	1	**Identify potential common shares** Stock options are potential common shares throughout the year because none have vested during the year.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the stock options are classified as equity (see section 6.9A.20). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step i	Number of options (and shares to be issued on exercise of the options)[1]	100,000	(A)
	Exercise price	$30	(B)
	Future services[2]	$750,000	(C)
	Assumed proceeds	$3,750,000	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$42.00	(E)
	Number of common shares deemed repurchased	89,286	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	100,000	(G)
	Incremental shares	10,714	(G) – (F)

Step	Basic EPS	Step	Diluted EPS
			Notes: 1. (100,000 share options outstanding at beginning of year + 100,000 share options outstanding at end of year) ÷ 2 = 100,000 shares assumed issued. 2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense.

Unrecognized compensation cost at beginning of the period:	
Total share options outstanding	100,000
Grant-date fair value per share option	× $9
Unrecognized compensation cost at beginning of the period	**$900,000**

Annual compensation cost recognized during the year:	
Share options estimated to vest	100,000
Grant-date fair value per option	$9
Total estimated compensation	$900,000
Divide by vesting period	÷ 3 years
Annual compensation cost recognized during the year	**(300,000)**
Compensation cost not recognized on share options outstanding at end of the year:	**600,000**
Average unrecognized compensation during the year[1]	**$750,000**

Note:
1. [(900,000 + 600,000) / 2 = 750,000]

Step	Basic EPS	Step	Diluted EPS
3	**Determine basic EPS** Basic EPS = $2,500,000 ÷ 1,500,000 = $1.67	3	**Rank the potential common shares** This step does not apply, because the stock options are the only class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.67 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The stock options are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$2,500,000	1,500,000	$1.67	
Stock options	-	10,714		
Total	**$2,500,000**	**1,510,714**	$1.65	✓

Therefore, ABC includes the effect of the stock options in diluted EPS.

Diluted EPS = $1.65

Question 6.9A.65

What is the basis for the average unearned compensation calculation for liability-classified share-based payment awards that are considered equity-classified for EPS?

Interpretive response: Liability-classified share-based payment awards are remeasured at each reporting period, with the remeasurement adjustment recorded as compensation expense. When calculating average unearned compensation as part of the treasury stock method, average unearned compensation is based on the amount that would be recorded had the instrument been classified in equity (i.e. grant-date fair value), and not the remeasured value. See Example 6.9A.35.

Question 6.9A.70

How are forfeitures of share-based payment awards included in EPS calculations?

Interpretive response: All outstanding share-based payment awards are reflected in the calculation of assumed proceeds from the exercise of the share options. Regardless of the entity's accounting policy election for the treatment of forfeitures, the potentially dilutive shares used in the denominator of the diluted EPS calculation are based on the actual number of options or shares granted and not yet forfeited. [260-10-45-29A, 718-10-45-1]

The entity's election regarding forfeitures affects how undistributed earnings are allocated to share-based payment awards when the awards are participating securities (see chapter 5). When an entity has a policy to estimate forfeitures, the effect of the forfeitures on the two-class method calculation for share-based payment awards is summarized in the following table.

	Awards vested (or expected to vest)	**Awards not expected to vest**
Accounting treatment of dividends or dividend equivalents	Retained earnings	Compensation cost
Earnings allocation under two-class method for basic EPS:		
— Distributed earnings	Allocated	Not allocated because already deducted from numerator
— Undistributed earnings	Allocated	Allocated
Denominator to calculate basic EPS for participating award	Weighted-average shares outstanding	Weighted-average shares outstanding

In contrast, if an entity elects to account for forfeitures when they occur, it allocates undistributed earnings to share-based payment awards for which the requisite service is not rendered because of forfeitures during the period. When an entity has elected to recognize forfeitures when they occur, awards forfeited during the period are weighted for the portion of the period the awards were outstanding.

An entity's estimate of the number of awards for which the requisite service is not expected to be rendered – or no estimate, if the entity has elected to account for forfeitures when they occur – for the purpose of determining EPS should be consistent with the estimate used for recognizing compensation cost.

Question 6.9A.72

How are redeemable share-based payment awards included in EPS calculations?

Interpretive response: Redeemable share-based payment awards are treated similarly to redeemable common shares – see also Question 3.3.20. The effect on basic EPS depends on whether the instruments are redeemable at fair value.

- **Redeemable at fair value.** No effect. Because the redemption feature is at fair value, it does not represent an economic benefit to the holders that is different from what is received by other shareholders; this is because the shares could be sold on the open market. Therefore, changes in the carrying amount do not represent an in-substance preferential distribution that should be considered when calculating EPS.
- **Redeemable at other than fair value.** The share-based payment awards include an in-substance preferential distribution when the redemption amount is greater than fair value. Increases or decreases in the carrying amount of the redeemable instrument are reflected in the EPS calculation using an approach similar to the two-class method (see section 5.3.10). See also section 6.13 as the EPS effect also depends on whether the instrument is equity- or liability-classified.

If the redemption feature is contingent, there is no numerator adjustment for the period that the redemption feature is not probable (see Question 3.3.22). Once redemption becomes probable, the instrument is treated as a redeemable instrument (i.e. there is a numerator adjustment).

Regardless of whether the redemption is at fair value, the denominator is only affected in diluted EPS. The instruments are included in the EPS denominator using the treasury stock method (and any numerator adjustments are reversed).

Question 6.9A.75

Can share-based payment awards be grouped together to determine if they are in-the-money?

Interpretive response: Options and warrants will have a dilutive effect on EPS if they are in-the-money. When considering if options or warrants are in-the-money, each share-based payment award is considered separately. This is consistent with the guidance in Topic 260 that each class of potential common shares is considered separately in calculating diluted EPS. However, awards with the same terms (e.g. exercise price, vesting period) may be considered in the aggregate (see section 4.3). [260-10-45-17]

Question 6.9A.78

How are share-based payment awards that are participating securities included in EPS?

Interpretive response: Share-based payment awards that are participating securities are included in basic EPS using the two-class method. For diluted EPS, the more dilutive of the two-class method or the treasury stock method is used. See chapter 5.

Question 6.9A.80

If the number of common shares is discretionary under a share-based payment award with a performance condition, when are these potential common shares included in the calculation of diluted EPS?

Interpretive response: If the number of shares awarded is based on the discretion of the compensation committee (or Board of Directors), we believe one acceptable approach is to include potential common shares in the denominator when calculating diluted EPS only after the discretion uncertainty is resolved. This method is consistent with the treatment of contingently issuable shares, which indicates that diluted EPS reflects only those share options that would be issued if the end of the reporting period were the end of the contingency period. [260-10-45-48]

Another acceptable approach is to include the potential shares issuable in diluted EPS based on an estimate of probable shares to be issued, provided that the minimum stated threshold for the performance condition is satisfied as of the reporting date. If the minimum threshold is not satisfied, none of the shares should be included in the denominator. This approach is consistent with the recognition of the compensation cost for these shares and the accounting for the potential common shares if they were not subject to an act of discretion by the compensation committee (or Board of Directors).

The accounting policy elected should be consistently applied.

Question 6.9A.90

Should unvested shares that vest on satisfaction of a service period or a performance condition be considered outstanding when calculating diluted EPS?

Background: On January 1, Year 6, ABC Corp. grants unvested shares to its employees. The employees will vest in the shares if:

- ABC's basic EPS for the year ending December 31, Year 7 is 20% higher than its basic EPS for the year ended December 31, Year 5; or
- the employee completes three years of service from the date of grant.

ABC's basic EPS for the year ended December 31, Year 6 is 10% higher than its basic EPS for the year ended December 31, Year 5.

Interpretive response: Yes, because the share-based payment awards issued will eventually vest regardless of whether the performance condition is met. As such, the performance condition only serves to potentially accelerate vesting rather than to prevent vesting.

In the background example, even if ABC has not yet met the EPS target, or it does not appear to be on track to meet the EPS target, the employees will be able to vest in the awards if they are still employed on December 31, Year 8. As such, these awards are not considered to be contingently issuable shares, and the awards are considered as outstanding when calculating diluted EPS. In contrast, the awards would be considered contingently issuable if they vest only when both a service period and a performance condition are met.

Using the treasury stock method to calculate diluted EPS

Unvested shares granted to employees are the equivalent of an option or warrant and the dilutive effect of these awards is reflected in diluted EPS by applying the treasury stock method. Therefore, once an entity determines which unvested shares are considered to be outstanding, it calculates their dilutive effect by applying the treasury stock method. It typically will assume a zero exercise price because there is no exercise price to be paid; however, there could be unamortized compensation that should be considered proceeds when applying the treasury stock method. In this scenario, the average unrecognized compensation is based on the three-year attribution period. [260-10-45-22, 45-28A, 45-29]

Question 6.9A.93

If an entity records compensation cost for a share-based payment award with a performance condition, are those shares included in diluted EPS?

Interpretive response: Not necessarily. Under Topic 718 (share-based payments) an entity records compensation cost for a share-based payment award with a performance condition when it is probable that the performance condition will be met. Potential common shares that are subject to a performance condition are included in diluted EPS after evaluating the contingency guidance in Topic 260 (see sections 6.10 and 6.11). These shares are included in the diluted EPS calculation only if the contingency would have been met if the end of the reporting period were the end of the contingency period. Therefore, an entity might record compensation cost for an award in the income statement but not include the potential common shares in its diluted EPS calculation. [260-10-45-31, 718-10-25-20]

Example 6.9A.40

Unvested common shares – without dividend entitlement

ABC Corp. grants 50,000 unvested common shares to its employees, on January 1, March 1 and April 1, Year 1. The shares have different vesting periods and are not entitled to dividends during the vesting period. The transactions are equity-settled share-based payment awards under Topic 718.

The grant-date fair value of each of the unvested shares is:

— **$6.50 for January 1** (vesting on December 31, Year 1)
— **$5.75 for March 1** (vesting on December 31, Year 2)
— **$5.00 for April 1** (vesting on December 31, Year 3).

Share-based payment expense recognized[1] under Topic 718 is as follows.

Grant date	Year 1	Year 2	Year 3	Total
Jan 1	$ 325,000	$ –	$ –	**$ 325,000**
March 1	130,682	156,818	–	**287,500**
April 1	68,182	90,909	90,909	**250,000**
Total	**$ 523,864**	**$ 247,727**	**$ 90,909**	**$ 862,500**

Note:

1. ABC accounts for forfeitures as they occur. There were no forfeitures during Year 2.

ABC has 3,000,000 common shares outstanding on January 1, Year 2. The average market price per common share in Year 2 is $6.

Net income for Year 2 is $4,600,000.

EPS calculations – Year 2

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary because the unvested shares are not entitled to non-forfeitable dividends or undistributed earnings. The numerator is $4,600,000.	1	**Identify potential common shares** Unvested common shares are potential common shares throughout the year, because they are treated as the equivalent of options until they are vested.
2	**Determine the denominator** The first grant of shares, vested on December 31, Year 1, is included in the denominator from the beginning of Year 2. The second grant only vests on December 31, Year 2, and therefore carries a weighing of 0/12 in Year 2. The third grant, which does not vest until December 31, Year 3 is not included in the basic EPS calculation.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the unvested shares are classified as equity (see section 6.8). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step	Basic EPS

	Number of shares	Time weight.	Weighted average
Common shares outstanding	3,000,000		
Shares vested on Dec. 31, Year 1	50,000		
Jan. – Dec.	3,050,000	12/12	3,050,000
Shares vested on Dec. 31, Year 2	50,000	0/12	0
		12/12	
Weighted average for the year			**3,050,000**

Therefore, the denominator is 3,050,000.

Step	Diluted EPS

Step i	Future services[1]	$214,773	(A)
	Assumed proceeds	$214,773	(B) = (A)
Step ii	Average market price of common shares	$6.00	(C)
	Number of common shares deemed repurchased	35,795	(D) = (B) ÷ (C)
Step iii	Weighted-average potential common shares outstanding[2]	100,000	(E)
	Incremental shares	64,205	(E) – (D)

Notes:

1. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense:
   - Unrecognized compensation cost at beginning of year: $156,818 + $90,909 + $90,909 = $338,636
   - Unrecognized compensation cost at end of year: $90,909
   - Average unrecognized compensation cost: $214,773
2. Potential common shares outstanding is the weighted average for the period.
   [2nd grant (50,000 × 365 ÷ 365) + 3rd grant (50,000 × 365 ÷ 365) = 100,000]

3 Determine basic EPS

Basic EPS = $4,600,000 ÷ 3,050,000 = $1.51

3 Rank the potential common shares

This step does not apply, because the unvested shares are the only class of potential common shares.

Step	Basic EPS	Step	Diluted EPS
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.51 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The unvested shares are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,050,000	$1.51	
Unvested common shares		64,205		
Total	**$4,600,000**	**3,114,205**	$1.48	✓

Therefore, ABC includes the effect of the second and third grants of unvested shares in diluted EPS.

Diluted EPS = $1.48

For an illustration of a situation with dividend entitlement, see Example 6.10.30.

Example 6.9A.50

EPS for share-based payment awards – with forfeitures

ABC Corp. has 1,500,000 shares outstanding at January 1, Year 1. ABC institutes its first share option plan in Year 1.

On January 1, Year 1, ABC grants 100,000 stock options with an exercise price equal to the market price of the share at that date ($30). The fair value of each stock option granted is $9 and the options cliff vest at the end of three years. ABC's accounting policy is to estimate forfeitures, and it expects that 85,000 of the options granted in Year 1 will vest. Assume a 21% tax rate.

ABC calculates compensation cost of $765,000 (85,000 × $9) at grant date, to be recognized ratably at $255,000 per year pursuant to Topic 718.

The following information is also relevant.

- Net income for the year was $2,500,000.
- During Year 1, 5,000 stock options were forfeited evenly during the year and ABC expects the same amount of forfeitures during each of the next two years.
- The average market price of ABC's shares during Year 1 is $42.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary until the options are exercised and convertible instruments are converted and common shares are issued. The numerator is $2,500,000.	1	**Identify potential common shares** Stock options are potential common shares throughout the year, because none have vested during the year.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the stock options are classified as equity (see section 6.9A.20). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step	Basic EPS	Step	Diluted EPS

Step i	Number of options (and shares to be issued on exercise of the options)[1]	97,500	(A)
	Exercise price	$30	(B)
	Future services[2]	$735,000	(C)
	Assumed proceeds	$3,660,000	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$42.00	(E)
	Number of common shares deemed repurchased	87,143	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	97,500	(G)
	Incremental shares	10,357	(G) – (F)

Notes:

1. (100,000 share options outstanding at beginning of year + 95,000 share options outstanding at end of year) ÷ 2 = 97,500 shares assumed issued.
2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense:

Step	Basic EPS	Step	Diluted EPS	
			Unrecognized compensation cost at beginning of the period:	
			Total share options outstanding	100,000
			Grant-date fair value per share option	× $9
			Unrecognized compensation cost at beginning of the period	**$900,000**
			Annual compensation cost recognized during the year:	
			Share options estimated to vest	85,000
			Grant-date fair value per option	$9
			Total estimated compensation	$765,000
			Divide by vesting period	÷ 3 years
			Annual compensation cost recognized during the year	**(255,000)**
			Compensation cost not recognized on share options outstanding at end of the year:	
			(100,000 – 5,000 actual forfeitures)	95,000
			Less: share options estimated to vest	(85,000)
			Actual share options outstanding at end of the year	10,000
			Grant-date fair value per option	× $9
				$90,000
			Divide by vesting period	÷ 3 years
			Compensation cost not recognized on share options outstanding at end of the year	**(30,000)**

Step	Basic EPS	Step	Diluted EPS

Total compensation cost actually forfeited during the year:	
Actual forfeitures during the year	5,000
Grant-date fair value per option	× $9
	(45,000)
Unrecognized compensation cost at year-end[i]	$570,000
Unrecognized compensation cost at beginning of the year	$900,000
Average unrecognized compensation during the year	**$735,000**

Notes:

i. Unrecognized compensation at year-end is: $900,000 – $255,000 – $30,000 – $45,000. The $570,000 unrecognized compensation cost at year-end can also be calculated as:
   - Expense to be recognized in Years 2 and 3 (after forfeiture assumption):
     - Year 2: 100,000 shares × $9 × 85% ÷ 3 years = $255,000
     - Year 3: 100,000 shares × $9 × 85% ÷ 3 years = $255,000
   - Forfeitures related to Year 2 and 3 less recognized in Year 1: (95,000 – 85,000) × $9 ÷ 3 × 2 = $60,000
   - Unrecognized compensation cost at year-end: $255,000 + 255,000 + 60,000 = $570,000

ii. An alternative way of calculating the average unrecognized compensation cost for Year 1 is: Unrecognized cost at the beginning of the year [100,000 × $9] + unrecognized cost at the end of the year [95,000 × $9 × 2/3] = $735,000.

Step	Basic EPS	Step	Diluted EPS
3	**Determine basic EPS** Basic EPS = $2,500,000 ÷ 1,500,000 = $1.67	3	**Rank the potential common shares** This step does not apply, because the stock options are the only class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.67 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The stock options are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$2,500,000	1,500,000	$1.67	
Stock options	-	10,357		
Total	**$2,500,000**	**1,510,357**	$1.65	✓

Therefore, ABC includes the effect of the second and third grants of unvested shares in diluted EPS.

Diluted EPS = $1.65

Example 6.9A.60

EPS for share-based payment awards – negative (no) incremental shares

Assume the same information as in Example 6.9A.50, except that the average market price of ABC Corp. shares during Year 1 is $36.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary until the options are exercised and convertible instruments are converted and common shares are issued. The numerator is $2,498,500.	1	**Identify potential common shares** Stock options are potential common shares throughout the year, because none have vested during the year.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the stock options are classified as equity (see section 6.9A.20). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step i	Number of options (and shares to be issued on exercise of the options)[1]	97,500	(A)
	Exercise price	$30	(B)
	Future services[2]	$735,000	(C)
	Assumed proceeds	$3,660,000	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$36.00	(E)
	Number of common shares deemed repurchased	101,667	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	97,500	(G)

Step	Basic EPS	Step	Diluted EPS
			| | **Incremental shares** | (4,167)[3] | (G) – (F) | Notes: 1. (100,000 share options outstanding at beginning of year + 95,000 share options outstanding at end of year) ÷ 2 = 97,500 shares assumed issued. 2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This is equal to the average unearned compensation expense – see calculation in Example 6.9A.50. 3. Effect on EPS is antidilutive; therefore, options are excluded from weighted-average shares outstanding.
3	**Determine basic EPS** Basic EPS = \$2,498,550 ÷ 1,500,000 = \$1.67	3	**Rank the potential common shares** This step does not apply, because the stock options are the only class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is \$1.67 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** Applying the treasury stock method results in a negative number of incremental shares. Therefore, the effect is antidilutive. Diluted EPS is the same as basic EPS. Diluted EPS = \$1.67

Question 6.9A.94

How is the treasury stock method applied to instruments such as unvested stock and RSUs?

Background: The treasury stock method calculates the number of incremental shares to be included in diluted EPS as the number of shares issuable per the terms of the instrument less shares assumed to be repurchased with the proceeds from the exercise, if there is an exercise. Topic 260 requires the assumed proceeds from exercise of the instrument be divided by the average market price of the shares during the period to determine the number of shares to be repurchased. For instruments such as unvested stock or RSUs, there are no assumed proceeds, other than future compensation, if any, in a share-based payment arrangement. [260-10-45-23]

Interpretive response: If there are no proceeds to consider when the treasury stock method is applied to unvested stock and RSUs, the incremental number of shares included is the same as the number of shares issuable per the terms of the instrument. See also sections 6.8 and 6.9A.

Example 6.9A.70

EPS for RSUs

ABC Corp. has 1,500,000 shares outstanding at January 1, Year 1. ABC institutes its first share option plan in Year 1.

On July 1, Year 1, ABC grants 50,000 RSUs. The fair value of each share is $9 and the RSUs cliff vest at the end of three years. ABC's accounting policy is to estimate forfeitures, and it expects that 3% of the RSUs will not vest overall by the end of the three-year period.

ABC calculates compensation cost of $436,500 (50,000 × 97% × $9) at grant date, to be recognized ratably at $145,500 per year under Topic 718.

The following information is also relevant.

- During Year 1, 250 RSUs were forfeited evenly during the period they were outstanding; ABC expects the same amount of forfeitures during the following years.
- The average market price of ABC's shares since the grant date is $8.50.
- The RSUs do not participate in dividends.
- Net income for the year is $2,700,000.
- ABC has a 21% tax rate.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary until the RSUs are vested. The numerator is $2,700,000.	1	**Identify potential common shares** RSUs are potential common shares from issuance date, because none have vested during the year.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,500,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* No adjustment is required because the RSUs are classified as equity (see section 6.9A.20). *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step i	Number of RSUs	49,875	(A)
	Exercise price	$0	(B)
	Future services[2]	$411,563	(C)
	Assumed proceeds	$411,563	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$8.50	(E)
	Number of common shares deemed repurchased	48,419	(F) = (D) ÷ (E)
Step iii	Weighted-average potential common shares outstanding[1]	49,875	(G)
	Incremental shares	1,456	(G) – (F)

Step	Basic EPS	Step	Diluted EPS
			Notes: 1. (50,000 RSUs outstanding at beginning of year + 49,750 RSUs outstanding at end of year) ÷ 2 = 49,875 shares issued. 2. In this step, the proceeds are those from future services to be rendered by the employee for the remaining period not vested. This equals the average unearned compensation expense.

Unrecognized compensation cost at beginning of the period:	
Total RSUs	50,000
Grant-date fair value per RSU	× $9
	$450,000

Compensation cost recognized during the year:	
RSUs estimated to vest	48,500
Grant-date fair value per RSU	$9
Total estimated compensation	$436,500
Divide by vesting period	÷ 3 years
Less: Compensation cost recognized during the year (for 6/12 of the year)	**145,500 × 6/12 = ($72,750)**
Compensation cost not recognized on RSUs at end of the year:	
(50,000 – 250 actual forfeitures)	49,750
Less: RSUs estimated to vest	(48,500)
Actual RSUs outstanding at end of the year	1,250
Grant-date fair value per RSU	× $9

Step	Basic EPS	Step	Diluted EPS	
				$11,250
			Divide by vesting period	÷ 3 years
			Portion of the year RSUs outstanding	× 6 /12
			Less: compensation cost not recognized on RSUs outstanding at end of the year	**(1,875)**
			Total compensation cost actually forfeited during the year:	
			Actual forfeitures during the year	250
			Grant-date fair value per RSU	× $9
				(2,250)
			Unrecognized compensation cost at year-end[i]	$373,125
			Unrecognized compensation cost at beginning of the year	$450,000
			Average unrecognized compensation during the year	**$411,563**

Note:

i. Unrecognized compensation at year end is: $450,000 – $72,750 – $1,875 – $2,250. The $373,125 unrecognized compensation cost at year-end can also be calculated as:
   - Expense to be recognized in Years 2, 3 and 4 (after forfeiture assumption):
     - Year 2: 50,000 shares × $9 × 97% ÷ 3 years = $145,500
     - Year 3: 50,000 shares × $9 × 97% ÷ 3 years = $145,500
     - Year 4: 50,000 shares × $9 × 97% ÷ 3 years × 6/12 = $72,750

Step	Basic EPS	Step	Diluted EPS
			— Forfeitures related to Years 2 - 4 less recognized in Year 1: (49,750 – 48,500) × \$9 ÷ 3 × 2.5 = \$9,375 — Unrecognized compensation cost at year-end: \$145,500 + \$145,500 + \$72,750 + \$9,375 = \$373,125
3	**Determine basic EPS** Basic EPS = \$2,700,000 ÷ 1,500,000 = \$1.80	3	**Rank the potential common shares** This step does not apply, because the RSUs are the only class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is \$1.80 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The RSUs are dilutive because no adjustment to the numerator for EPIS is required.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	\$2,700,000	1,500,000	\$1.80	
Incremental RSUs		1,456		
Total	**\$2,700,000**	**1,501,456**	\$1.80	✓

Although there appears to be no difference, in fact when rounding to three decimal places there is a difference: \$1.800 as compared to \$1.798.

Therefore, ABC presents both basic and diluted EPS.

Diluted EPS = \$1.80

Question 6.9A.95

Are unvested RSUs included in basic EPS?

Interpretive response: No, unvested RSUs are considered contingently returnable and are not included in basic EPS. RSUs are included in basic EPS from the date they are vested. For guidance on contingently returnable and unvested shares see section 6.8.

Question 6.9A.100

What is the effect of share-based payment awards related to the former subsidiary and former parent on EPS subsequent to a spinoff?

Background: As a result of a spinoff transaction, employees of the former parent (spinnor) may receive unvested equity instruments of the former subsidiary (spinnee), or employees of the former subsidiary may retain unvested equity instruments of the former parent.

Interpretive response: Diluted EPS for the spinnor includes the dilutive effect of all outstanding share-based payment awards. The shares assumed issued on exercise of the share-based payment awards include the potentially dilutive effect from all awards held in the spinnor's shares regardless of whether the awards are held by spinnor or spinnee employees. This is because the awards were granted as a consequence of employment with the spinnor.

However, the calculation of the assumed proceeds from the exercise of awards in the spinnor's treasury stock includes only the average unrecognized compensation cost for the spinnor's awards held by spinnor employees. Unrecognized compensation cost for the spinnee awards held by the spinnor's employees and unrecognized compensation cost for the spinnor awards held by spinnee employees are not included in the assumed proceeds.

The numerator for both basic and diluted EPS calculations includes the compensation cost recognized for awards in spinnor and spinnee held by spinnor employees. There is no adjustment to the numerator to exclude compensation cost recognized by spinnor for spinnee awards held by spinnor's employees.

The following table describes the spinnor's application of the treasury stock method. This guidance also applies from the perspective of the spinnee and the awards held by its employees and spinnor employees. See also Question 6.17.30.

	Applying treasury stock method
Spinnor employees	
Spinnor options	Adjust assumed proceeds for unrecognized compensation cost; compensation cost included in numerator (i.e. compensation cost recognized is not adjusted)
SpinCo options	Not reflected in denominator; compensation cost included in numerator (i.e. compensation cost recognized is not adjusted)
SpinCo employees	
Spinnor options	Included in denominator using treasury stock method with no adjustment for unrecognized compensation cost; no impact on numerator (i.e. no compensation cost recognized)
SpinCo options	Not reflected in numerator (i.e. no compensation recognized) nor in denominator

Question 6.9A.105

How does a modification of an award affect EPS?

Interpretive response: An entity may change the terms of a share-based payment award, which results in a modification as defined under Topic 718. When there is a modification of a share-based payment award, we believe the entity treats the pre- and post-change awards as two separate awards. This entails two separate treasury stock method calculations: one for the period that the pre-change awards were outstanding, and the other for the period that the post-change awards were outstanding.

Question 6.9A.120

What is the EPS effect of the remeasurement of a liability-classified share-based payment award?

Interpretive response: The remeasurement is part of the share-based payment cost recognized in the income statement and therefore already included in earnings. In addition, because the treasury stock method is used for share-based payment awards, there generally is no adjustment to the numerator for the remeasurement under the treasury stock method, unless the share-based payment award is liability-classified for accounting purposes but presumed to be equity-settled for EPS purposes (see section 6.13A). [260-10-45-29]

Question 6.9A.130

How is EPS affected by the early exercise of stock options?

Background: For tax purposes, sometimes, an entity will allow a grantee to exercise a share-based payment award early (i.e. before the award is vested or exercisable). The entity has the ability to repurchase the shares if they ultimately do not vest (i.e. if the goods or services are not provided).

Interpretive response: Shares resulting from the early exercise of stock options are treated similarly to unvested shares for EPS purposes. They are not considered outstanding and therefore not included in basic EPS until all the vesting conditions are met.

For diluted EPS, the treasury stock method is applied, with other conditions for vesting (e.g. performance conditions) being evaluated under the guidance for contingently issuable shares – see section 6.10. When applying the treasury stock method, because there are no future proceeds, as the cash has already been paid as part of the early exercise, the cash received is not included in the calculation of assumed proceeds. See section 6.8 for further discussion on unvested shares. [260-10-45-13, 45-22, 45-28A]

If the instruments are entitled to non-forfeitable dividends, the two-class method is applied to basic EPS, and the more dilutive of the two-class or the treasury stock method is used in diluted EPS. See chapter 5. [260-10-45-61A

Example 8 in Topic 260 (reproduced below) also illustrates the treasury stock method for share-based payment awards.

Excerpt from ASC 260-10

• > Example 8: Application of the Treasury Stock Method to a Share-Based Payment Arrangement

55-68 This Example illustrates the guidance in paragraph 260-10-45-28A for the application of the treasury stock method when share options are forfeited.

55-69 Entity A adopted a share option plan on January 1, 20X7, and granted 900,000 at-the-money share options with an exercise price of $30. All share options vest at the end of three years (cliff vesting). Entity A's accounting policy is to estimate the number of forfeitures expected to occur in accordance with paragraph 718-10-35-1D or 718-10-35-3. At the grant date, Entity A assumes an annual forfeiture rate of 3 percent and therefore expects to receive the service for 821,406 [900,000 × (.97 to the third power)] share options. On January 1, 20X7, the fair value of each share option granted is $14.69. Grantees forfeited 15,000 stock options ratably during 20X7.

55-69A The average stock price during 20X7 is $44. Net income for the period is $97,385,602. For the year ended December 31, 20X7, there are 25,000,000 weighted-average common shares outstanding. This guidance also applies if the service inception date precedes the grant date.

55-70 The following table illustrates computation of basic and diluted EPS for the year ended December 31, 20X7.

Computation of Basic EPS for the Year Ended December 31, 20X7:		
Net income		$ 97,385,602
Weighted-average common shares outstanding		25,000,000
Basic earnings per share		$ 3.90
Computation of assumed proceeds for diluted earnings per share:		
Amount employees would pay if the weighted-average number of options outstanding were exercised using the average exercise price (892,500[b] × $30)		$ 26,775,000
Average unrecognized compensation cost in 20X7 (see computation)		10,944,050
Assumed proceeds		$ 37,719,050
Computation of average unrecognized compensation cost in 20X7:		
Beginning of period		
Unrecognized compensation cost (900,000 × $14.69)		$ 13,221,000
End of the period		
Beginning of the period	$ 13,221,000	
Annual compensation cost recognized during 20X7, based on estimated forfeitures	(4,022,151)[a]	
Annual compensation cost not recognized during the period related to outstanding options at December 31, 20X7, for which the requisite service is not expected to be rendered	(311,399)[c]	
Total compensation cost of actual forfeited options	(220,350)[d]	
Total unrecognized compensation cost, end of the period, based on actual forfeitures		8,667,100

Subtotal	$ 21,888,100
Average total unrecognized compensation, based on actual forfeitures	$ 10,944,050
Assumed repurchase of shares:	
Repurchase shares at average market price during the year ($37,719,050 ÷ $44)	857,251
Incremental shares (892,500 – 857,251)	35,249
Computation of Diluted EPS for the Year Ended December 31, 20X7:	
Net income	$ 97,385,602
Weighted-average common shares outstanding	25,000,000
Incremental shares	35,249
Total shares outstanding	25,035,249
Diluted earnings per shares	$ 3.89

a. Pre-tax annual share-based compensation cost is $4,022,151 [(821,406 × $14.69) ÷ 3]
b. Share options granted at the beginning of the year plus share options outstanding at the end of the year divided by two equals the weighted-average number of share options outstanding in 20X7: [(900,000 ÷ 885,000) ÷ 2] = 892,500. This example assumes that forfeitures occurred ratably throughout 20X7.
c. 885,000 (options outstanding at December 31, 20X7) – 821,406 (options for which the requisite service is expected to be rendered) = 63,594. 63,594 options × $14.69 (grant-date fair value per option) = $934,196 (total fair value). $934,196 ÷ 3 = $311,399 (annual share-based compensation cost).
d. 15,000 (forfeited options) × $14.69 (grant-date fair value per option) = $220,350 (total fair value).

6.9A.60 Forward sale contracts

Forward sale contracts are obligations that require the entity to sell its common stock in exchange for cash or other assets. In general, forward sale contracts are included in diluted EPS using the treasury stock method (see sections 4.4.40 and 6.9.30).

Forward sale contracts that are classified as assets or liabilities generally require a numerator adjustment (see section 4.4.30). The adjustment is equivalent to the after-tax fair value adjustment that was recorded during the period.

Forward sale contracts may have different settlement alternatives:

- physically settled (i.e. 'gross settlement', exchange of shares for cash at settlement date);
- net-share settled (out-of-the-money party pays in-the-money party net shares with a value equal to gain at settlement); or
- net-cash settled.

The EPS effect of forward sale contracts depends on both their method of settlement and whether the number of shares to be issued, or the contract price, is fixed or variable.

The following table shows the EPS effect of forward sale contracts indexed to an entity's own common shares. The table assumes that the forward sale contract in question is not a participating security as described in section 5.2. If there are multiple possible forms of settlement, the entity should presume share settlement, if more dilutive, as discussed in section 6.13. [260-10-45-45]

See Question 6.15.30 for guidance on forward purchase contracts.

Type of contract	Basic EPS	Diluted EPS
Equity-classified physically settled forward sale for a fixed number of shares	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method).
Liability-classified physically settled forward sale for a fixed number of shares	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method) considering the numerator adjustment for the after-tax remeasurement gain or loss.
Liability-classified physically settled forward sale for a variable number of shares	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method) considering the numerator adjustment for the after-tax remeasurement gain or loss. Include shares based on contingently issuable shares guidance discussed in section 6.10, if relevant, or guidance on variable denominator discussed in Question 6.15.35.
Liability-classified net share-settled forward sale	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method) considering the numerator adjustment for the after-tax remeasurement gain or loss.
Equity-classified net share-settled forward sale	Not considered in basic EPS.	Apply Topic 260 to determine dilutive effect (treasury stock method[1]).

Type of contract	Basic EPS	Diluted EPS
		When this type of forward sale contract is in a gain position, the entity will receive shares upon settlement. Because Topic 260 specifically states that the denominator is increased in diluted EPS, we believe in such scenarios the effect should not be included, because the contract would reduce, not increase, the denominator. [260-10-45-16]
Asset- or liability-classified net cash-settled forward sale	Not considered in basic EPS. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders.	Not considered in calculating diluted EPS because the contract does not allow share settlement. The numerator is not adjusted to exclude the effect of the contract on income available to common shareholders.
Equity-classified physically settled prepaid forward sale for a fixed number of shares	Include shares to be issued in basic EPS because shares will be issued for no consideration based only on passage of time. See Question 6.9.150. [260-10-45-13]	No incremental effect – shares are already included in basic EPS. See Question 6.9A.150
Equity- or liability-classified physically settled prepaid forward sale contract for variable number of shares	Include minimum number of shares to be issued, if any, in basic EPS because these shares will be issued for no consideration based only on the passage of time. See Question 6.9.150. [260-10-45-13]	Apply Topic 260 to determine dilutive effect under the treasury stock method[1]. Include incremental shares, that are not already included in basic EPS, based on relevant guidance on multiple conversion or exercise bases (in section 4.4.40) or contingent share guidance beginning at paragraph 260-10-45-48 (discussed in section 6.10). See Question 6.9A.150[1].

Note:

1. In this scenario there are no future cash proceeds; therefore, the incremental shares under the treasury stock method are determined by number of shares issuable under the contract.

Question 6.9A.140
Are all forward sale contracts included in diluted EPS?

Interpretive response: No. Only forward sale contracts that will result in the issuance of shares is included in diluted EPS.

Net-cash settled forward sale contracts

Net-cash settled forward sale contracts are not included in diluted EPS because they will always settle in cash and shares will not be issued.

Forward sale contracts that are physically settled in shares

Forward sale contracts that are physically settled in shares are included in diluted EPS if the effect is dilutive, even if they are out-of-the-money from the holder's perspective (average share price is less than exercise price), in contrast to options and warrants that are not included in diluted EPS when they are out-of-the-money. This is because such forward sale contracts will always be settled by issuance of shares whether they are in-the-money or out-of-the-money, unlike options and warrants.

Forward sale contracts that are net-share settled

Forward sale contracts that are net-share settled are included in diluted EPS only if they are in-the-money from the holder's perspective (average share price is greater than exercise price). Whether the contract is in-the-money must be determined at each reporting period. Net-share settled forward sale contracts that are out-of-the-money from the holder's perspective would result in a reduction of shares when calculating the denominator for diluted EPS. Because Topic 260 specifically states that the denominator is increased in diluted EPS, we believe the effect of net-share settled forward sale contracts that are out-of-the-money from the holder's perspective should not be included, because the contract would reduce, not increase, the denominator. [260-10-45-16]

Observation
Forward sale contracts that are out-of-the-money

A forward sale contract that is uneconomical from the holder's perspective, i.e. out-of-the-money based on the *period-end* price, might still be dilutive and included in diluted EPS if it is physically settled. This is because 'in-the-money' from a Topic 260 perspective is determined by comparing the average share price to the forward contract price. Similarly, the treasury stock method uses the average market price for the year. As long as the average market price is higher than the forward sale contract price, the contract is dilutive, regardless of whether the share price at the end of the reporting period is higher or lower than the forward sale contract price.

Question 6.9A.150

How are prepaid forward sale contracts included in basic and diluted EPS?

Interpretive response: Prepaid forward sale contracts are certain to be settled in shares. However, because the purchase price is prepaid, there are no future proceeds to account for in the treasury stock method. In calculating the shares to be included in diluted EPS, instead of calculating the denominator adjustment using the proceeds, the number of shares to be issued under the prepaid forward sale contract is used. How the shares are included in EPS depends on whether they are settled in a fixed or variable number of shares.

— **Fixed prepaid forward sale contracts**. Because the contract price is prepaid for a fixed number of shares, they are treated for EPS purposes as contingently issuable shares issuable for little or no cash or other consideration, subject only to the passage of time. Therefore, because all conditions for their issuance, other than the passage of time, have been met they are included in basic EPS. There is no further effect on diluted EPS, as they are already included in basic EPS. See section 6.10. [250-10-45-13]

— **Variable prepaid forward sale contracts**. There may be a minimum number of shares that is part of the contract terms, when the forward sale contract is prepaid for a variable number of shares. The minimum number of shares feature is similar to a fixed prepaid forward sale contract, and those shares are included in basic EPS, with no additional effect on diluted EPS. An entity evaluates whether the variable shares are to be included in diluted EPS following the guidance on contingently issuable shares and multiple conversion or exercise bases, if relevant (see sections 4.4.40 and 6.10). A numerator adjustment may also be required if the instrument is liability-classified but share-settled (see section 4.4.30). [260-10-45-13, 45-21A]

6.12A Convertible instruments

Excerpt from ASC 260-10

• > Convertible Securities and the If-Converted Method

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.

b. If an entity has convertible debt outstanding:

   1. Interest charges applicable to the convertible debt shall be added back to the numerator.
   2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.
   3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).

c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator.

45-41 In applying the if-converted method, conversion shall not be assumed for purposes of computing diluted EPS if the effect would be antidilutive. Convertible preferred stock is antidilutive whenever the amount of the dividend declared in or accumulated for the current period per common share obtainable on conversion exceeds basic EPS. Similarly, convertible debt is antidilutive whenever its interest (net of tax and nondiscretionary adjustments) per common share obtainable on conversion exceeds basic EPS.

45-42 Dilutive securities that are issued during a period and dilutive convertible securities for which conversion options lapse, for which preferred stock is redeemed, or for which related debt is extinguished during a period, shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive convertible securities converted during a period shall be included in the denominator for the period prior to actual conversion. The common shares issued upon actual conversion shall be included in the denominator for the period after the date of conversion.

Consequently, shares assumed issued shall be weighted for the period the convertible securities were outstanding, and common shares actually issued shall be weighted for the period the shares were outstanding.

• • > Contingently Convertible Instruments

45-43 While the terms of **contingently convertible instruments** vary, a typical instrument includes a market price trigger that exceeds a specified conversion price of the issuer's underlying stock price on the date of issuance by a specified percentage (for example, 10 percent, 20 percent, or 30 percent). Some contingently convertible instruments have floating market price triggers for which conversion is dependent upon the market price of the issuer's stock exceeding the conversion price by a specified percentage or percentages at specified times during the term of the debt. Other contingently convertible instruments require that the market price of the issuer's stock exceed a specified level for a specified period (for example, 20 percent above the conversion price for a 30-day period). In addition, contingently convertible instruments may have additional features such as parity features, issuer call options, and investor put options.

45-44 Contingently convertible instruments shall be included in diluted EPS (if dilutive) regardless of whether the market price trigger has been met. There is no substantive economic difference between contingently convertible instruments and conventional convertible instruments with a market price conversion premium. The treatment for diluted EPS shall not differ because of a contingent market price trigger. The guidance provided in this paragraph also shall be applied to instruments that have multiple contingencies if one of the contingencies is a market price trigger and the instrument is convertible or settleable in shares based on meeting a market condition—that is, the conversion is not dependent (or no longer dependent) on a substantive non-market-based contingency. For example, this guidance applies if an instrument is convertible upon meeting a market price trigger or a substantive non-market-based contingency (for example, a change in control). Alternatively, if the instrument is convertible upon achieving both a market price trigger and a substantive non-market-based contingency, this guidance would not apply until the non-market-based contingency has been met. See Example 11 (paragraph 260-10-55-78) for an illustration of this guidance.

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

45-40 The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the **if-converted method**. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.
b. If an entity has convertible debt outstanding:

1. Interest charges applicable to the convertible debt shall be added back to the numerator. For convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator.
2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.
3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).

c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator.

45-44 Contingently convertible instruments shall be included in diluted EPS (if dilutive) regardless of whether the market price trigger has been met. There is no substantive economic difference between contingently convertible instruments and ~~conventional~~ convertible instruments with a market price conversion premium. The treatment for diluted EPS shall not differ because of a contingent market price trigger. The guidance provided in this paragraph also shall be applied to instruments that have multiple contingencies if one of the contingencies is a market price trigger and the instrument is convertible or settleable in shares based on meeting a market condition—that is, the conversion is not dependent (or no longer dependent) on a substantive non-market-based contingency. For example, this guidance applies if an instrument is convertible upon meeting a market price trigger or a substantive non-market-based contingency (for example, a change in control). Alternatively, if the instrument is convertible upon achieving both a market price trigger and a substantive non-market-based contingency, this guidance would not apply until the non-market-based contingency has been met. See Example 11 (paragraph 260-10-55-78) for an illustration of this guidance.

6.12A.10 Overview of the instrument

Convertible instruments are instruments other than stand-alone options that by their terms may be converted in whole or in part into the common shares of an entity, such as convertible bonds or convertible preferred shares.

If the conversion option of these instruments is in the scope of Topic 815, the derivative conversion option is recognized at fair value through earnings, or equity component, depending on their terms. For example, a bond with an embedded option to convert it into common shares of the issuer is a hybrid instrument that contains a financial liability and an embedded derivative, if the conversion option is required to be bifurcated from the host and accounted for separately as a derivative. [815-15-25-1]

A convertible instrument may also contain a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date. This instrument is commonly called stock-settled debt. [480-10-25-14(a)]

This section does not address:

— the extinguishment of liabilities with common shares as a result of a renegotiation of the terms of the liabilities (see section 6.5); or
— stand-alone options issued in conjunction with liabilities, such as a bond that is tendered as payment of the exercise price of an option and a bond that is required to be redeemed using proceeds from the exercise of options (see section 6.9A).

For further discussion of:

— contracts that contain settlement alternatives, see section 6.13A.
— convertible preferred shares, see section 6.14.

6.12A.20 EPS implications

Generally, convertible instruments affect only diluted EPS. However, instruments that are mandatorily convertible into common shares can affect basic EPS.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X Denominator X / ✓	Numerator ✓ Denominator ✓
Nonmandatorily convertible instruments do not affect basic EPS until they are converted. Generally, common shares issued on the conversion of such convertible instruments are included in the denominator from the date on which the common shares are issuable (see section 3.4.10). Mandatorily convertible instruments are generally included in the denominator from the date on which they are converted because they are not considered to be outstanding common shares until conversion (see Question 3.4.10). A mandatorily convertible instrument may have participation rights, in which case EPS is calculated using the two-class method. [260-10-45-59A – 45-60]	Convertible instruments are potential common shares because they may entitle their holders to an entity's common shares. The potential adjustments to the numerator include the after-tax amount of any dividends or interest, fair value gains or losses (e.g. fair value option, or fair value adjustments for instruments that are otherwise remeasured to fair value) and other consequential changes in income or expense that would result from the assumed conversion. An example of other consequential changes in income or expense' may be the adjustment to depreciation expense if the interest on a convertible instrument has been capitalized into the cost of

<table>
<tr><th>Potential effect on basic EPS</th><th>Potential effect on diluted EPS</th></tr>
<tr><td></td><td>property, plant and equipment under Subtopic 835-30 (see section 4.4A.30).

The potential adjustment to the denominator is based on the additional common shares resulting from the assumed conversion. Conversion is assumed to have occurred at the beginning of the period; or on the date of issuance of the convertible instrument, if later. [260-10-45-40]

Contingently convertible instruments are evaluated to determine if they should be included in the diluted EPS calculation, based on the guidance in section 6.10. Once it is determined that they should be included in diluted EPS, they are included according to the guidance in this section, and using the number of shares/conversion price guidance in section 6.10. Convertible securities (as opposed to other instruments) with a market price contingency are included in diluted EPS regardless of the market price contingency. See also Question 6.12A.10.</td></tr>
<tr><td colspan="2">Dilutive or antidilutive?

Generally, a convertible bond is antidilutive when its after-tax interest (and other consequential changes in income or expense) per common share obtainable on conversion exceeds basic EPS from continuing operations. Similarly, a convertible preferred share is generally antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per common share obtainable on conversion exceeds basic EPS from continuing operations (see section 6.14). However, because diluted EPS is calculated in sequence, a convertible instrument may be dilutive on its own, yet antidilutive when considered in sequence with other instruments. [260-10-45-41]

Unlike for options, warrants and their equivalents (see section 6.9A), market conditions in a convertible instrument are ignored when calculating diluted EPS. Further, the market price of common shares relative to the conversion price of convertible instruments is irrelevant in deciding whether a particular convertible instrument is dilutive. A convertible instrument may be dilutive even though the embedded conversion option is out-of-the-money. [260-10-45-44]

Dilutive effect of participating securities

Assumed conversion or exercise of many participating securities may be antidilutive because they already receive an allocation of earnings in calculating basic EPS. Therefore, usually they will only be antidilutive if their share of earnings is higher assuming conversion or exercise, and this is not offset by the other assumptions inherent in these calculations – e.g. repurchase of common shares with proceeds of exercise for a participating stock option.

However, if the entity has a loss, and the instrument does not participate in the loss, there is no allocation of earnings (losses) in calculating basic EPS. An instrument will generally be antidilutive if the effect of numerator adjustments (for after-tax interest, fair value adjustments) is greater than the effect of the additional shares issuable upon conversion.</td></tr>
</table>

6.12A.30 Interpretive analysis and examples

Question 6.12A.10

Can securities that become convertible in the future be included in diluted EPS if not currently convertible?

Background: Convertible securities include instruments that by their terms may be converted into common shares, such as convertible debt and convertible preferred shares. Convertible securities may be convertible based on the passage of time or the achievement of a defined share price, or they may be convertible in the future based on satisfying certain conditions or a future event.

Interpretive response: It depends. Instruments that become convertible based solely on the passage of time are included in diluted EPS even if not currently convertible. Convertible securities that become convertible in the future based on satisfying certain conditions represent contingently convertible potential common shares. Whether they are included in diluted EPS depends on the nature of the contingency. [260-10-45-55]

— **Securities become convertible based on achieving a defined share price (market price trigger).** Include in diluted EPS using the if-converted method even if they are not currently convertible. When there is a market price trigger in a *convertible* instrument, the contingency is ignored and the instruments are included in diluted EPS regardless; this is different from other instruments with a market price trigger (see sections 6.10.20 and 6.11.20).

— **Securities become convertible based on earnings or other targets (other than market price).** Include in diluted EPS if they would have been included had the reporting date been the end of the contingency period, and assuming no change in the condition (i.e. no further earnings) until the end of the contingency period.

— **Securities become convertible upon the occurrence of a specified event.** Include only when the event occurs.

This contingent share guidance is described more fully in section 6.10.

Question 6.12A.20

How is EPS affected by nonmandatorily convertible instruments with conversion features that are based on the market price of an entity's common shares?

Interpretive response: It depends on whether an entity is obligated to settle the instrument in shares or simply has the right to do so. When an entity has an obligation to settle the instrument in shares (as discussed in Question 4.4A.50), to determine the exchange ratio for the if-converted method, we believe the entity should use the market price of its common shares at the end of the period or the average of the preceding period, whichever is most relevant to the terms of the agreement. [260-10-45-21]

We believe the analysis is different when an entity has the right but not the obligation to settle an instrument in a variable number of shares constituting a fixed monetary amount. In this instance, the entity should evaluate the contract to determine whether it expects that the instrument will be settled in cash or shares; share settlement is presumed unless the entity can overcome this presumption (see section 6.13A). If the instrument is presumed to be shared-settled, it is included in diluted EPS using the if-converted method and following the guidance in the preceding paragraph to determine the number of shares to be added.

Observation

Contingently convertible instruments vs contingently issuable shares

The contingency in a contingently convertible instrument is evaluated similarly to contingently issuable shares (see section 6.10) except if there is a market price conversion trigger. A market price conversion trigger in a *contingently convertible instrument* is ignored when evaluating if the contingency will be met – i.e. it is assumed to be met regardless of whether the market price conversion trigger has been met. However, when the conversion price varies based on the market price, the guidance for contingently issuable shares subject to a market price is used to determine the conversion price/number of shares to include in the denominator.

Question 6.12A.25

How is EPS calculated for a contingently convertible instrument with variable conversion rates based on the market price?

Interpretive response: A contingently convertible instrument with a market price trigger is treated differently from a contingently issuable share with a similar trigger. A contingently convertible instrument with a market price trigger is included in diluted EPS regardless of whether the market price trigger was met.

However, when the conversion rate varies based on the market price, an entity instead follows the guidance for contingently issuable shares subject to a market price contingency to determine the conversion rate. When this is the case, the entity does not ignore the market price at the end of the period (or average for the period, if relevant).

See also the flowchart at section 4.3 and Question 6.18A.60.

Question 6.12A.30

How is EPS affected by equity commitment or equity contract notes?

Background: Equity commitment notes and equity contract notes are debt instruments that provide for the issuing entity, generally at its discretion, to repay the debt at maturity using cash proceeds from the issuance of either common shares or preferred shares. An issuing entity repays equity commitment notes with cash proceeds from the sale of either common or preferred shares, whereas equity contract notes obligate the holder to take either common or preferred shares in lieu of cash to repay the debt.

Interpretive response: We believe an entity considers equity contract notes that specifically require the issuance of common shares to repay debt to be potentially dilutive securities and includes them in calculations of diluted EPS using the if-converted method.

Question 6.12A.40

How is EPS affected by instruments with more than one conversion feature?

Interpretive response: In some cases, an entity may issue an instrument with more than one conversion feature. This can lead to uncertainty over which conversion feature should be considered when determining the potential common shares for inclusion in the diluted EPS calculation.

For example, convertible bonds may be issued with two conversion features attached to the nonmandatory convertible instruments: an option for early conversion and an option for conversion at the end of a contingent period. The goal in calculating diluted EPS is to determine the maximum potential dilutive effect. Therefore, we believe the entity should separately calculate diluted EPS for the early conversion feature and the conversion at the end of the contingent period to evaluate which feature is most dilutive. The presentation of the diluted EPS is based on the most dilutive scenario. [260-10-45-18]

Question 6.12A.50

How is EPS affected by a convertible instrument with a conversion option that is more advantageous to the holder?

Background: A convertible instrument may have a conversion option that permits the holder to pay cash or tender other securities for a more favorable conversion rate.

Interpretive response: When more than one conversion alternative exists, diluted EPS is calculated using the alternative that is most advantageous to the holder. See also Question 6.12A.60 [260-10-55-8 – 55-9]

Question 6.12A.60

How is EPS affected by a convertible instrument that permits or requires the holder to pay cash at conversion?

Interpretive response: Convertible securities that permit or require the holder to pay cash at conversion are treated as, in substance, warrants. The treasury stock method is used to calculate the denominator, assuming the purchase of common shares for the assumed cash proceeds. However, the if-converted method is also used to adjust the numerator for the effect(s) of the convertible instrument. See also Example 6.12A.30. [260-10-55-11]

Example 6.12A.10

Convertible debt

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

- On January 1, Year 1, ABC issues 1,000,000 convertible bonds for $1 each. Every 10 bonds are convertible into one common share at the holder's discretion. There is no beneficial conversion feature.
- The interest expense for the year relating to the convertible bonds is $100,000. The interest expense is tax-deductible, and the applicable income tax rate is 21%.

Net income for Year 1 is $4,600,000.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary until the convertible bonds are converted and common shares are issued. The numerator is $4,600,000.	1	**Identify potential common shares** The convertible bonds are the only potential common shares.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS: The full conversion of the bonds would increase income for the year by the after-tax amount of the interest expense:* (*interest* expense on the convertible bonds) × (1 – income tax rate) = ($1*00,000) × (1 – 21%) = $79,000* *Potential adjustment to the denominator for EPIS: The full conversion of the bonds would increase the number of outstanding shares by 100,000 (1,000,000 ÷ 10).* EPIS is therefore $79,000 ÷ 100,000 = $0.79
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53	3	**Rank the potential common shares** This step does not apply, because the convertible bonds are the only class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.53 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Convertible bonds	79,000	100,000		
Total	**$4,679,000**	**3,100,000**	$1.51	✓

Step	Basic EPS	Step	Diluted EPS
			Therefore, ABC includes the effect of the convertible bonds in diluted EPS. Diluted EPS = $1.51

Example 6.12A.20

Contingently convertible debt with a market price trigger

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1 ABC issues contingently convertible debt on. The debt holder may convert its debt into common shares when the share price exceeds the market price trigger. The debt holder is entitled only to the par value of the debt if they do not convert the debt.

The following additional facts are relevant.

- The principal amount of the convertible debt is $1,000,000 (1,000 convertible bonds of $1,000 par value each).
- The conversion ratio is 40, with a conversion price of $25 (convertible bond's par value of $1,000 ÷ the conversion ratio of 40).
- The share price of common shares at issuance is $20.
- The average share price for Year 1 is $30,
- The market price trigger provides that the average share price for the year must exceed $33 (130% of the conversion price).
- The interest rate is 4%.
- The effective tax rate is 21%.

Income available to common shareholders for the year ended December 31, Year 1 is $4,600,000.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** The contingently convertible debt is the only potential common share.

Step	Basic EPS	Step	Diluted EPS
2	**Determine the denominator** No adjustment is necessary. The denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS: Because this is a convertible instrument, the market price trigger is ignored. The full conversion of the debt would increase income for the year by the after-tax amount of the interest expense:* (*interest* expense on the convertible bonds) × (1 – income tax rate) = ($4*0,000) × (1 – 21%) = $31,600* *Potential adjustment to the denominator for EPIS: The full conversion of the debt would increase the number of outstanding shares by 40,000 ($1,000,000 ÷* $25). EPIS is therefore $31,600 ÷ 40,000 = $0.79
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53	3	**Rank the potential common shares** This step does not apply, because the contingently convertible debt is the only class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.53 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of the convertible debt is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Convertible debt	31,600	40,000		
Total	**$4,631,600**	**3,040,000**	$1.52	✓

Therefore, ABC includes the effect of the convertible bonds in diluted EPS.

Step	Basic EPS	Step	Diluted EPS
			Diluted EPS = $1.52 ABC includes the dilutive effect of the convertible debt in its diluted EPS even though ABC has not met the market price trigger of $33, because the market price contingency is ignored for convertible instruments with market triggers.

Example 6.12A.30

Convertible securities that require cash payment upon conversion

ABC Corp. has 3,000,000 common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC issues 1,000,000 convertible bonds for $1 each.

- Every 100 bonds are convertible into one common share at the holder's discretion, and the holder must also pay $5 per share upon conversion.
- The average market price of ABC's common shares during Year 1 is $110.
- The average market price of each bond during Year 1 is $100.

Net income for Year 1 is $4,600,000, which includes interest expense of $100,000 on the bonds. The interest expense is tax deductible and the applicable income tax rate is 21%.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** The convertible bonds are potential common shares for the period during which they are outstanding. Further, because the terms require the holder to pay cash when converting, the convertible securities are treated as warrants.
2	**Determine the denominator** No adjustment is necessary until the options are exercised and common shares are issued, because they	2	**For each potential common share, calculate EPIS** The value of ABC's common stock is greater than the bonds, and therefore it is assumed that bonds will be

<table>
<tr><th>Step</th><th>Basic EPS</th><th>Step</th><th>Diluted EPS</th></tr>
<tr><td></td><td>are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.</td><td></td><td>
converted, and cash tendered upon conversion (because it is more advantageous for the holder). Therefore, $50,000 [(1,000,000 ÷ 100) × $5.00] is assumed proceeds in applying the treasury stock method.
Potential adjustment to the numerator for EPIS: The if-converted method is used to account for the conversion of the bond (the impact to the numerator).
Conversion would increase income for the year by the post-tax amount of the interest expense:
(interest expense on the bonds) × (1 – income tax rate) = ($100,000) × (1 – 21%) = $79,000
Potential adjustment to the denominator for EPIS:
The treasury stock method is used for the impact of the denominator to account for the cash proceeds received. If the bonds were converted without any additional cash paid, the adjustment would be 10,000 shares ($1,000,000 ÷ 100). However, because the holder is also required to pay cash, the convertible instrument is treated as a warrant and the adjustment is determined using the treasury stock method, as follows.
<table>
<tr><td rowspan="3">Step i</td><td>Number of shares to be issued upon bond conversion</td><td>10,000</td><td>(A)</td></tr>
<tr><td>Exercise price</td><td>$5</td><td>(B)</td></tr>
<tr><td>Assumed proceeds</td><td>50,000</td><td>(C) = ((A) × (B))</td></tr>
<tr><td rowspan="2">Step ii</td><td>Average market price of common shares</td><td>$110.00</td><td>(D)</td></tr>
<tr><td>Number of common shares deemed repurchased</td><td>455</td><td>(E) = (C) ÷ (D)</td></tr>
<tr><td>Step iii</td><td>Incremental shares</td><td>9.545</td><td>(A) – (E)</td></tr>
</table>
EPIS is therefore $79,000 ÷ 9,545 = $8.28
</td></tr>
</table>

Step	Basic EPS	Step	Diluted EPS
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53	3	**Rank the potential common shares** This step does not apply, because the convertible bonds are the only class of potential common shares considered.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.53 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of the convertible bonds is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Bond conversion	79,000	9,545		
Total	**$4,679,000**	**3,009,545**	$1.55	✗

To the extent that the convertible bonds are antidilutive, their effect is not considered in diluted EPS, which results in the same amount as basic EPS.

Diluted EPS = $1.53

6.12A.40 Unit structures

A unit structure is a type of financing transaction that typically involves a unit offering combining debt or convertible preferred shares and a forward contract to issue a variable number of common shares (forward contract). The par value of the debt or preferred shares typically equals the price to be received by the issuer on the forward contract.

This type of transaction may enable an entity to meet its capital needs while offering unique features such as the ability to remarket the underlying debt or preferred shares. Unit structures may be marketed by different financial institutions under the name PRIDES, FELINE PRIDES or DECS. From the holder's perspective the unit structure offers similar benefits to a convertible instrument.

Generally, the forward contract is legally detachable and separately exercisable from the debt or preferred shares. In addition, the debt or preferred shares will be remarketed to other investors at a subsequent date (generally starting three months before the maturity of the forward contract). The intent is to have a successful remarketing that allows the original investor to either use the remarketing proceeds to satisfy the obligation under the forward contract or hold on to the remarketed debt or preferred shares until maturity.

If the remarketing fails, then depending on the terms of the unit structure the investor may have the option to, or may be required to, tender the debt or preferred shares to the issuer to satisfy the forward contract.

Each unit structure has unique terms that the issuer must evaluate to determine the EPS effect of the unit structure. Among the factors to be considered, and which are discussed in this section, are:

- whether the components of the unit structure are participating securities (see Question 6.12.70),
- how diluted EPS is calculated for unit structures with debt instruments (see Question 6.12.80),
- whether changes in the likelihood of a successful remarketing affect diluted EPS (see Question 6.12.90).

The terms of unit structures involving preferred shares could differ significantly from those involving debt instruments. Therefore, significant judgment is necessary based on facts and circumstances to apply the appropriate method to compute diluted EPS.

Question 6.12A.70

Are the components of unit structures considered participating securities and, if so, what are the EPS implications?

Interpretive response: It depends. If the forward contract is entitled to participate in earnings with common shares, then it is a participating security. Such participation right may not be explicit and may come in the form of an adjustment to the forward price when dividends on common shares are declared. See section 5.2 for further guidance on identifying participating securities. [260-10-45-63]

If the forward contract is a participating security, the two-class method is applied when calculating basic EPS. We believe an entity calculates diluted EPS using the more dilutive of the two-class method or applicable diluted EPS method (i.e. treasury stock or if-converted, see Question 5.7.10). See chapter 5 for guidance on applying the two-class method. [260-10-45-60A]

Question 6.12A.80

How is diluted EPS calculated for unit structures involving a debt instrument?

Background: In a unit structure, if the remarketing is successful, the investor can elect to either:

— retain the debt instrument with the revised interest rate for its remaining term; or
— sell the debt instrument in the remarketing for cash.

In either case, the investor would have to purchase the common shares under the forward contract for cash.

On the other hand, if the remarketing is unsuccessful, the investor can elect to either:

— tender the debt instrument; or
— pay cash in settlement of the forward contract.

In some cases, tendering the debt instrument may be required.

Interpretive response: It depends. Topic 260 presumes that the holder would tender the debt instrument to satisfy the forward contract unless it is more advantageous to the holder to tender cash. [260-10-55-9]

We believe to calculate diluted EPS, the entity must first evaluate the probability of a successful remarketing. If it determines a successful remarketing is probable, it cannot presume the holder will tender the debt instrument (because the option would not be available). Instead, it presumes cash will be tendered, and therefore calculates diluted EPS using the treasury stock method for the forward contract (there is no EPS effect for the debt instrument because it is not convertible, i.e. not a potential common share). [260-10-55-9]

If a successful remarketing is not deemed probable, the entity calculates diluted EPS assuming the holder tenders the debt instrument in settlement of the forward contract. In this case, we believe the if-converted method should be applied to the unit structure in its entirety, with the shares resulting from the forward contract added to the diluted EPS denominator. [260-10-55-9]

If the forward contract is liability-classified (see chapter 6 in KPMG Handbook, Debt and equity financing, for classification guidance), under either method there is an adjustment to the diluted EPS numerator for any remeasurement that was recorded as income or expense during the period (see section 4.4.30 and Question 4.4.40).

Question 6.12A.90

Can a change in the likelihood of a successful remarketing affect diluted EPS?

Interpretive response: Yes, when the option of tendering the debt is based on a successful remarketing, we believe an entity should monitor all unit structure transactions to determine whether the likelihood of a successful remarketing is no longer probable. In addition, we believe the likelihood of a successful remarketing will need to be assessed for each unit structure separately because the debt instruments could have different features.

A change in the expected success of a remarketing affects diluted EPS prospectively. For example, a successful remarketing may have initially been deemed probable, and the treasury stock method used to include the forward contract in the diluted EPS calculation. However, if the expectation changes and a successful remarketing is no longer deemed probable and tendering of the debt instrument would then be allowed, the debt instrument would be deemed to have been tendered and the if-converted method would be used to include the forward contract in diluted EPS.

6.13A Contracts that may be settled in shares or in cash

See section 6.13 for guidance on contracts that may be settled in shares or in cash after the adoption of ASU 2020-06.

Excerpt from ASC 260-10

• > Contracts That May Be Settled in Stock or Cash

45-45 If an entity issues a contract that may be settled in common stock or in cash at the election of either the entity or the holder, the determination of whether that contract shall be reflected in the computation of diluted EPS shall be made based on the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Topic) if the effect is more dilutive. Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46. An example of such a contract is a written put option that gives the holder a choice of settling in common stock or in cash.

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b). The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

45-47 Paragraphs 260-10-55-32 through 55-36A provide additional guidance on contracts that may be settled in stock or cash.

• > Contracts That May Be Settled in Stock or Cash

55-32 Adjustments shall be made to the numerator for contracts that are classified, in accordance with Section 815-40-25, as equity instruments but for which the entity has a stated policy or for which past experience provides a reasonable basis to believe that such contracts will be paid partially or wholly in cash (in which case there will be no potential common shares included in the denominator). That is, a contract that is reported as an equity instrument for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an asset or liability for accounting purposes during the period. For purposes of computing diluted EPS, the adjustments to the numerator are only permitted for instruments for which the effect on net income (the numerator) is different depending on whether the instrument is accounted for as an equity instrument or as an asset or liability (for example, those that are within the scope of Subtopics 480-10 and 815-40).

55-33 The references in paragraphs 260-10-45-30 and 260-10-45-45 for share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee refer to using the guidance in paragraph 260-10-45-45 for purposes of determining whether shares issuable in accordance with such plans are included in the denominator for purposes of computing diluted EPS amounts. Accordingly, the numerator is not adjusted in those circumstances. Paragraph 260-10-55-36A illustrates these requirements.

55-36 For contracts in which the counterparty controls the means of settlement, past experience or a stated policy is not determinative. Accordingly, in those situations, the more dilutive of cash or share settlement shall be used.

55-36A The following table illustrates the guidance in paragraphs 260-10-55-32 through 55-36 for the effects of contracts that may be settled in stock or cash on the computation of diluted EPS.

Assumed Settlement for EPS Purposes [(a)]	Accounting for Book Purposes (per Topic 480 or 815)	Adjustment Required to Book Earnings (Numerator) for Purposes of Computing Diluted Earnings per Share? [(b)]	Adjustment Required to Number of Shares Included in Denominator? [(b)]
Shares	Asset/Liability	Yes (per paragraph 260-10-45-45)	Yes
Shares	Equity	No	Yes
Cash	Asset/Liability	No	No
Cash	Equity	Yes (per Topic 260)	No

(a) Note that for purposes of computing EPS, delivery of the full stated amount of cash in exchange for delivery of the full stated number of shares (physical settlement) should be considered share settlement.

(b) Except for forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash. Topic 480 provides EPS guidance for those contracts.

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

45-45 The effect of potential share settlement shall be included in the diluted EPS calculation (if the effect is more dilutive) for an otherwise cash-settleable instrument that contains a provision that requires or permits share settlement (regardless of whether the election is at the option of the entity or the holder, or the entity has a history or policy of cash settlement). An example of such a contract accounted for in accordance with this paragraph and paragraph 260-10-45-46 is a written call option that gives the holder a choice of settling in common stock or in cash. An election to share settle an instrument, for purposes of applying the guidance in this paragraph, does not include circumstances in which share settlement is contingent upon the occurrence of a specified event or circumstance (such as **contingently issuable shares**). In those circumstances (other than if the contingency is an entity's own share price), the guidance on contingently issuable shares should first be applied, and, if the contingency would be considered met, then the guidance in this paragraph should be applied. ~~If an entity issues a contract that may be settled in common stock or in cash at the election of either the entity or the holder, the determination of whether that contract shall be reflected in the computation of diluted EPS shall be made based on the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Topic if the effect is more dilutive.~~ Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46, unless the share-based payment arrangement is classified as a liability because of the requirements in paragraph 718-10-25-15 (see paragraph 260-10-45-45A for guidance on those instruments). If the payment of cash is required only upon the final liquidation of an entity, then the entity shall include the effect of potential share settlement in the diluted EPS calculation until the liquidation occurs. ~~An example of such a contract is a written put option that gives the holder a choice of settling in common stock or in cash.~~

45-45A For a share-based payment arrangement that is classified as a liability because of the requirements in paragraph 718-10-25-15 and may be settled in common stock or in cash at the election of either the entity or the holder, determining whether that contract shall be reflected in the computation of diluted EPS shall be prepared on the basis of the facts available each period. It shall be presumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant guidance in this Topic) if the effect is more dilutive. The presumption that the contract will be settled in common stock may be overcome if past experience or a state policy provides a reasonable basis to conclude that the contract will be paid partially or wholly in cash.

45-46 A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 260-10-45-40(b). ~~The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.~~

• > Contracts That May Be Settled in Stock or Cash

55-32 Adjustments shall be made to the numerator for contracts that are asset or liability classified, in accordance with Section 815-40-25, but for which the potential common shares are included in the denominator in accordance with the guidance in paragraph 260-10-45-45~~as equity instruments but for which the entity has a stated policy or for which past experience provides a reasonable basis to believe that such contracts will be paid partially or wholly in cash (in which case there will be no potential common shares included in the denominator). That is, a contract that is reported as an equity instrument for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an asset or liability for accounting purposes during the period~~. For purposes of computing diluted EPS, the adjustments to the numerator are only permitted for instruments for which the effect on net income (the numerator) is different depending on whether the instrument is accounted for as an equity instrument or as an asset or liability (for example, those that are within the scope of Subtopics 480-10 and 815-40).

55-33 The references in paragraphs 260-10-45-30 and 260-10-45-45 for share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee refer to using the guidance in paragraph 260-10-45-45A ~~260-10-45-45~~ for purposes of determining whether shares issuable in accordance with such plans are included in the denominator for purposes of computing diluted EPS amounts. Accordingly, the numerator is not adjusted in those circumstances. Paragraph 260-10-55-36A illustrates these requirements.

55-36 Paragraph superseded by Accounting Standards Update No. 2020-06.~~For contracts in which the counterparty controls the means of settlement, past experience or a stated policy is not determinative. Accordingly, in those situations, the more dilutive of cash or share settlement shall be used.~~

55-36A The following table illustrates the guidance in paragraphs 260-10-45-45 through 45-46 and 260-10-55-32 through 55-34 ~~55-36~~ for the effects of contracts that may be settled in stock or cash on the computation of diluted EPS.

Assumed Settlement for EPS Purposes [(a)]	Accounting for Book Purposes (per Topic 480 or 815)	Adjustment Required to Book Earnings (Numerator) for Purposes of Computing Diluted Earnings per Share? [(b)]	Adjustment Required to Number of Shares Included in Denominator? [(b)]
Shares	Asset/Liability	Yes (per paragraph 260-10-45-45)	Yes
Shares	Equity	No	Yes
Cash	Asset/Liability	No	No
~~Cash~~	~~Equity~~	~~Yes (per Topic 260)~~	~~No~~

(a) Note that for purposes of computing EPS, delivery of the full stated amount of cash in exchange for delivery of the full stated number of shares (physical settlement) should be considered share settlement.
(b) Except for forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash. Topic 480 provides EPS guidance for those contracts.

6.13A.10 Overview of the instrument

This section applies prior to adoption of ASU 2020-06 (see About this publication) and discusses contracts that contain settlement alternatives at the issuing entity's or the holder's option. An example of such contracts is a share warrant that can be settled either gross in common shares or net in cash.

Whether such a contract is included in diluted EPS depends on how the instrument is classified and who has the choice of settlement at each reporting date.

If the contract is in the scope of Topic 718 (share-based payments) and: [718-10-25-6 – 25-19]

- **the employee has the choice of settlement,** the contract is liability-classified, unless it is a 'combination' award – i.e. award with two or more components in which exercise of one part does not cancel the other(s), which is treated as a compound instrument.
- **the entity has the choice of settlement,** the entity accounts for the award as either liability- or equity-classified in its entirety, with liability classification required if there is a present obligation to settle in cash, or a past practice or stated policy of settling in cash.

If such a contract is in the scope of Topic 815 (derivatives and hedging), it may be a derivative, or an equity component, depending on its terms.

The requirements for classifying an instrument as an asset/liability versus equity differ from the requirement to presume share settlement when calculating diluted EPS; and this difference may require adjustments to the numerator and denominator when calculating diluted EPS. For example, a warrant may be liability-classified under Subtopic 815-40 (with changes in fair value recognized in earnings) yet still require a presumption of share settlement under Topic 260.

Convertible instruments under Subtopic 470-20 may impact income available to common shareholders while outstanding and upon conversion. See section 4.4A.30 for further discussion on adjustments to the numerator, and chapter 10 of KPMG Handbook, Debt and equity financing, for discussion about the accounting for such instruments.

This section discusses the EPS implications of contracts that may be settled in shares or in cash, including puts and calls on convertible debt. Additional considerations in the context of specific instruments are set out in the following sections:

- instruments under share-based payment awards, see section 6.9A; and
- convertible instruments and stock-settled debt, see section 6.12A.

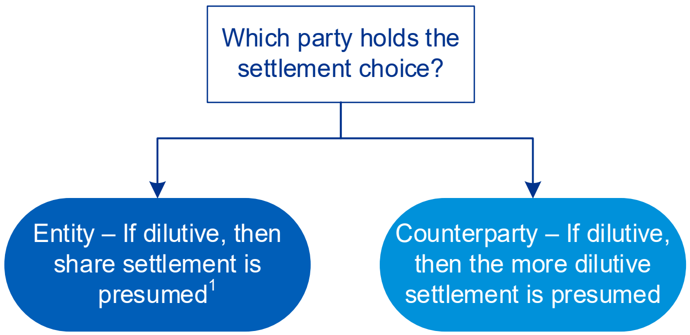
6.13A.20 EPS implications

Generally, contracts that may be settled in shares or in cash affect only diluted EPS. Whether the issuing entity or the holder has the settlement choice affects the settlement assumption in determining the denominator of the EPS calculation; however, the effect is ultimately determined with reference to the guidance that applies to the type of potential common share. The EPS presumption for these contracts (i.e. whether they are assumed converted) can also have a consequential effect on earnings, which affects the numerator in the EPS calculation.

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / Denominator X	Numerator X / ✓ / Denominator X / ✓
Contracts that may be settled in shares or in cash are generally ignored because they are not common shares.	Contracts that may be settled in shares or in cash may entitle their holder to common shares, and are therefore potential common shares. Depending on whether the entity or the counterparty has the settlement choice, the potential effect on diluted EPS under both the share-settlement and the cash-settlement assumptions may need to be considered. Under a share-settlement presumption: — the potential adjustment to the numerator depends on the accounting for the contract under Topic 718 (share-based payments) or Topic 815 (derivatives and hedging); and — the potential adjustment to the denominator is determined based on the relevant guidance in Topic 260 for the type of potential common share in question. For example: – for options, warrants and their equivalents, see section 6.9A; – for contingently issuable common shares and contingently issuable potential common shares, see sections 6.10 and 6.11; – for convertible instruments, see section 6.12A; and – for written put options and forwards, see section 6.15. A cash-settlement presumption may also result in a numerator adjustment for an equity-classified instrument under Topic 505 (equity) that is treated as an asset/liability for EPS purposes (see Question 6.13A.10).
Note: When a conditionally redeemable share becomes mandatorily redeemable under Topic 480 (distinguishing liabilities from equity), it requires reclassification to a liability. The entity measures the liability upon reclassification initially at fair value and reduces equity by the amount of that fair value, recognizing no gain or loss. Because this reclassification of equity to a liability is like the redemption of shares by issuance of debt, the SEC staff indicated in paragraph 480-10-S99-3A that, similar to the accounting for the redemption of preferred shares in paragraph 260-10-S99-2, to the extent that the fair value of the liability upon reclassification differs from the recorded amount of preferred shares (i.e. recorded in equity or temporary equity), that difference should be deducted from or added to net income available to common shareholders in the calculation of EPS.	

6.13A.30 Interpretive analysis and examples

The treatment of contracts that may be settled in shares or in cash in diluted EPS depends on whether the settlement choice rests with the entity or the counterparty. [260-10-45-45]



Note:

1. Unless past practice or stated policy of cash settlement.

When the entity controls the means of settlement

The presumption is that the entity will share settle if the entity is given the choice of settlement, and if that means of settlement is more dilutive. This involves calculating diluted EPS under both the share settlement and cash settlement presumptions to determine which is more dilutive. [260-10-45-45]

The presumption that a contract will be settled in common shares may be overcome if the entity controls the method of settlement and it (1) has a past practice or a stated policy that provides a reasonable basis to believe the contract will be settled partially or wholly in cash, and (2) can demonstrate the intent and ability to settle the contract in cash. [260-10-55-32, 2003 AICPA Conf]

When the counterparty controls the means of settlement

When the counterparty is given the choice of settlement, past experience or a stated policy is not relevant. Instead, in general the most dilutive settlement option is assumed, meaning the entity uses the more dilutive method of settlement (either cash or share settlement) to calculate diluted EPS. This involves calculating diluted EPS under both the share settlement and cash settlement presumptions to determine which is more dilutive.

Overcoming the presumption of share settlement

The SEC staff has stated that solely asserting that the entity has a stated policy of cash settlement is not sufficient to overcome the share settlement presumption. According to the SEC staff, an entity's stated policy 'must have substance if it is to be relied upon as the basis for excluding share settleable obligations' from the diluted EPS calculation. [2003 AICPA Conf]

The SEC staff further provided factors for an entity to consider in evaluating if its cash-settlement policy has substance. These factors are considered collectively, to determine if there is substance to an entity's cash settlement policy. [2003 AICPA Conf]

Factor	Considerations
Settlement alternatives as a selling point	Whether the ability to settle in shares was a contributing factor in the entity's decision for issuing the instrument
Intent and Ability	Whether the entity has a positive intent and ability to settle both the principal and interest in cash, considering both current and projected liquidity, and consistency with other assumptions of the entity
Disclosure Commensurate with Intent	Whether the disclosures in the financial statements and offering documents are consistent with the entity's intention and ability to settle in cash
Past Practice	Whether the entity has a past practice of settling in cash, when it has a choice between cash or share settlement

The following table highlights the effect on diluted EPS of different types of convertible debt instruments, as described by the SEC staff, that contain options for the entity (issuer) to settle all or a portion of the obligation in cash. [2003 AICPA Conf]

Convertible debt instrument type	Issuer's settlement option	Effect on diluted EPS	Diluted EPS calculation method
Instrument A	Issuer must settle the entire obligation in cash upon conversion	No effect (because cash settlement)	N/A
Instrument B	Issuer may settle the entire obligation in either shares or cash in an amount equal to the conversion value	Included in diluted EPS unless the issuer has past experience or a substantive stated policy that supports cash settlement [260-10-45-46]	If-converted method
Instrument C	Issuer must settle the accreted value in cash and the excess conversion premium (or conversion spread value) may be settled in cash or shares	Conversion premium (conversion spread value) is included in diluted EPS unless the issuer has past experience or a stated policy that supports cash settlement	Treasury stock method [260-10-55-84 – 84B]

Convertible debt instrument type	Issuer's settlement option	Effect on diluted EPS	Diluted EPS calculation method
		Because the instrument is cash settled, the numerator is *not* adjusted for interest expense on the instrument. However, a numerator adjustment may be required for mark-to-market adjustments of the conversion premium. [260-10-45-46, 55-84 – 84B]	
Instrument X	Issuer may settle principal and interest, as well as the conversion premium, in any combination of cash or shares	If issuer has past experience or a substantive stated policy to settle the principal in cash only, the diluted EPS effect is consistent with Instrument C Otherwise, the diluted EPS effect is consistent with Instrument B	Treasury stock method If-converted method

Question 6.13A.05

Is an assertion of cash settlement reviewed in future periods?

Interpretive response: Yes. We believe that at each reporting period an entity that asserts cash settlement should review its ability and intent to cash settle. Any changes in the assertion should be reflected in EPS on a prospective basis. We believe that an entity also should disclose when such a change is made.

Question 6.13A.10

How is EPS affected when the settlement conclusion for the instrument differs from the accounting treatment?

Interpretive response: The requirements for classifying an instrument as an asset/liability versus equity differ from the requirement to presume share settlement when calculating diluted EPS, and that difference may require an adjustment to the numerator and denominator when calculating diluted EPS. For example, a warrant may be liability classified under Subtopic 815-40 (with changes in fair value recognized in earnings) yet still be treated as share settled under Topic 260.

Similarly, adjustments are made to the numerator for contracts that are classified as equity instruments but for which the entity has a stated policy or past experience provides a reasonable basis to believe that these contracts will be paid partially or wholly in cash (in which case there will be no potential common shares included in the denominator). Specifically, although the instrument is equity classified, when considering the instrument for EPS purposes, it is treated as a liability because cash settlement is presumed. Therefore, the numerator is adjusted for after-tax interest or other adjustments (such as fair value adjustments) that would have been recorded in earnings had the instrument been classified as an asset or liability for book purposes.

The following table summarizes the guidance in paragraphs 260-10-55-32 to 55-36 for the effects of contracts that may be settled in cash or shares on the calculation of diluted EPS. For equity-classified instruments (i.e. those that do not use the if-converted method – e.g. convertible debt), this assumes that the instrument is in-the-money. No adjustment is necessary if the instrument is out-of-the-money (because zero shares would be added, under the treasury stock method).

Assumed settlement for EPS purposes[1]	For accounting purposes	Adjustment required to earnings (numerator) when calculating diluted EPS?[2]	Adjustment required to number of shares included in denominator?[2]
Shares	Asset/Liability	Yes	Yes
Shares	Equity	No	Yes
Cash	Asset/Liability	No	No
Cash	Equity	Yes	No

Notes:

1. Note that when calculating EPS, delivery of the full stated amount of cash in exchange for delivery of the full stated number of shares (physical settlement) is considered a share settlement.
2. Except for forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash. Topic 480 provides EPS guidance for those contracts.

Observation

Indicators vs criteria – numerator adjustments are limited to effect of cash-settlement assertion

For equity-classified instruments with a cash-settlement assertion, Topic 260 permits adjustments only to the numerator for instruments for which the effect on net income (the numerator) is different, depending on whether the instrument is accounted for as an equity instrument or as an asset or liability; for example, those that are in the scope of Subtopics 480-10 and 815-40. [260-10-55-32]

Question 6.13A.20

Are potential common shares associated with liability-classified warrants always included in diluted EPS when the warrants are in-the-money?

Interpretive response: Generally, yes. We believe an entity should include such an instrument in diluted EPS (as long as share settlement is presumed), even when the entity has a net loss, if the effect of the numerator and denominator adjustments is dilutive. This scenario is illustrated in Example 6.13A.10.

Observation

Liability-classified warrants – no effect on diluted EPS when cash settlement is presumed

When the entity's past practice demonstrates its intent and ability to settle in cash, the presumption of share settlement for diluted EPS may be overcome. This can happen, for example, with liability-classified warrants. When cash settlement is presumed, the instruments are not considered potential common shares and there are no diluted EPS implications. The treasury stock method is not applied because the instrument is not presumed to be exercised.

Example 6.13A.10

Potential common shares associated with liability-classified warrants that are in-the-money

ABC Corp. has a net loss of $4,600,000 and 3,000,000 weighted-average common shares outstanding during Year 1.

On January 1, Year 1, ABC issues warrants to buy 50,000 common shares at $10 per share.

- The warrants may be cash-settled at the entity's option.
- The warrants are classified as a liability under Subtopic 815-40, but the presumption for diluted EPS of share settlement is not overcome.
- The warrants are not participating securities.

ABC records a gain of $150,000 during the year due to changes in the fair value of the warrants. The average market price of ABC's common shares is $20 in Year 1.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $(4,600,000).	1	**Identify potential common shares** Warrants are exercisable for more than little consideration and the presumption of share settlement is not overcome. The warrants are therefore potential common shares for the period during which they are outstanding.
2	**Determine the denominator** No adjustment is necessary until the warrants are exercised and common shares are issued, because they are exercisable for more than little consideration. There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** For contracts that may be settled in common shares or cash at the entity's option, the entity presumes share settlement if more dilutive. Therefore, it calculates diluted EPS under both assumptions to determine which is more dilutive. *Cash-settlement assumption* Under this assumption, there is no adjustment to the denominator because cash settlement does not result in any additional common shares being issued. There is also no adjustment to the numerator, because the accounting for the liability at fair value under Subtopic 815-40 is based

Step	Basic EPS	Step	Diluted EPS
			on the cash alternative – i.e. the cash settlement does not result in consequential changes in earnings. *Share-settlement assumption* Under this assumption, the contract is settled in common shares, and the effect of the liability classification is reversed as a numerator adjustment. *Potential adjustment to the numerator for EPIS:* The exercise of the warrants would increase income for the year by the fair value adjustment: (fair value adjustment) × (1 – income tax rate) = ($150,000) × (1 – 21%) = $118,500 *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method, as follows.

Step i	Number of warrants (and shares to be issued on exercise of warrants)	50,000	(A)
	Exercise price	$10	(B)
	Assumed proceeds	$500,000	(C) = ((A) × (B))
Step ii	Average market price of common shares	$20.00	(D)
	Number of common shares deemed repurchased	25,000	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	25,000	(A) – (E)

EPIS is therefore $118,500 ÷ 25,000 = $4.74

Step	Basic EPS	Step	Diluted EPS
3	**Determine basic EPS** Basic EPS (loss per share) = $(4,600,000) ÷ 3,000,000 = $(1.53)	3	**Rank the potential common shares** This step does not apply, because the warrants are the only class of potential common shares considered.
		4	**Determine basic EPS from continuing operations** Basic EPS (loss per share) is $(1.53) (see Step 3 of basic EPS calculation).

Step	Basic EPS	Step	Diluted EPS
		5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of the options is determined as follows.

	Earnings (loss)	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$(4,600,000)	3,000,000	$(1.53)	
Exercise of warrants	(118,500)	25,000		
Total	**$(4,718,500)**	**3,025,000**	$(1.56)	✓

The warrants are dilutive, because they increase loss per share. Therefore, they are included in diluted EPS.

Share settlement is presumed for diluted EPS, because the share settlement alternative results in a ($1.56) EPS, and therefore it is more dilutive than the cash settlement alternative (which would be the same as basic EPS as there were no numerator or denominator adjustments to EPS when assuming cash settlement).

Diluted EPS = ($1.56)

Example 6.13A.30
Share-based payment – counterparty has the settlement choice

ABC Corp. has 3,000,000 shares of common shares outstanding on January 1, Year 1.

On January 1, Year 1, ABC grants the following share-based payment award to its CEO, conditional on the CEO remaining with ABC for two years. On completion of the service period, the CEO can choose between:

— 1,000,000 stock appreciation rights (SARs) to be settled in cash at the intrinsic value of each SAR (i.e. each SAR requires ABC to pay an amount equal to the appreciation in value of its stock) at the settlement date; or

— 1,000,000 stock options to be settled in ABC's common shares with an exercise price equal to ABC's share price at the grant date ($10).

The share-based payment award is accounted for as a liability-classified award under Topic 718, because the CEO can choose to settle in cash and the value of both options is the same. In addition, this award is not a combination award, because the CEO can choose one or the other settlement option but does not receive both.

The average market price of ABC's common shares during Year 1 is $11. Net income for Year 1 is $4,600,000.

Compensation expense

To calculate the compensation expense for Year 1, ABC determines the following fair values for the individual SAR under Topic 718:

— January 1, Year 1: $1.00
— December 31, Year 1: $1.30.

ABC calculates compensation expense for Year 1 of $650,000 [1,000,000 × $1.30 × 1/2]. The difference between the fair values at grant date and the reporting date is the portion recognized as a remeasurement expense: ($1.30 – $1.00) × 1,000,000 × 1/2 = $150,000. The remeasurement expense is tax-deductible, and the applicable income tax rate is 21%.

EPS calculations – Year 1

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** No adjustment is necessary. The numerator is $4,600,000.	1	**Identify potential common shares** The share-based payment award is considered a potential common share, because it may entitle the CEO to ABC's common shares.
2	**Determine the denominator** There is no change in the number of outstanding shares during the year. Therefore, the denominator is 3,000,000.	2	**For each potential common share, calculate EPIS** For contracts that may be settled in common shares or cash at the counterparty's option, the entity uses the more dilutive manner of settlement of either cash-settlement or share-settlement. *Cash-settlement assumption* Under this assumption, there is no adjustment to the denominator because cash settlement does not result in any additional common shares being issued. There is also no adjustment to the numerator, because the accounting

Step	Basic EPS	Step	Diluted EPS
			for the liability under Topic 718 is based on the fair value of the cash alternative – i.e. the cash-settlement does not result in consequential changes in earnings. *Share-settlement assumption* Under this assumption, the option can only be settled in common shares. *Potential adjustment to the numerator for EPIS:* The options, if they are exercised, would increase earnings for the year by the after-tax amount of the remeasurement expense: (remeasurement expense on the options) × (1 – iincome tax rate) = ($150,000) × (1 – 21%) = $118,500 *Potential adjustment to the denominator for EPIS:* The adjustment is determined using the treasury stock method (see section 6.9A) as follows.

Step i	Number of options (and shares to be issued on exercise of options)	1,000,000	(A)
	Exercise price	$10.00	(B)
	Future services[1]	$750,000	(C)
	Assumed proceeds	$10,750,000	(D) = ((A) × (B)) + (C)
Step ii	Average market price of common shares	$11.00	(E)
	Number of common shares deemed repurchased	977,273	(F) = (D) ÷ (E)
Step iii	**Incremental shares**	22,727	(A) – (F)

Note:

1. In this step, proceeds include the fair value of future services to be rendered by the CEO for the remaining period not vested. This is equal to the average unearned compensation expense:
   - Unrecognized compensation cost at beginning of

Step	Basic EPS	Step	Diluted EPS
			year: 1,000,000 × $1.00 = $1,000,000 — Unrecognized compensation cost at end of year: $1,000,000 × 1/2 = $500,000 — Average unrecognized compensation cost: ($1,000,000 + $500,000) ÷ 2 = $750,000 — Note that unearned compensation represents the proceeds in the calculation as there is no exercise price for SARs. EPIS is therefore $118,500 ÷ 22,727 = $5.21
3	**Determine basic EPS** Basic EPS = $4,600,000 ÷ 3,000,000 = $1.53	3	**Rank the potential common shares** This step does not apply, because there is only one class of potential common shares.
		4	**Determine basic EPS from continuing operations** Basic EPS is $1.53 (see Step 3 of basic EPS calculation).
		5	**Identify dilutive potential common shares and determine diluted EPS** Under the equity-settlement assumption, the effect of the equity-settlement alternative is presented as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$4,600,000	3,000,000	$1.53	
Incremental shares from stock options	118,500	22,727		
Total	**$4,718,500**	**3,022,727**	$1.56	✗

Because the equity-settlement assumption is not dilutive and the cash-settlement assumption would not result in adjustments to the numerator and denominator, diluted EPS is the same amount as basic EPS.

Diluted EPS = $1.53

Question 6.13A.40
Are dividends payable in either cash or shares subject to the guidance on contracts that may be settled in shares or cash?

Interpretive response: No. Dividends that may be paid in cash or shares are not considered contracts that may be settled in shares or cash and are not subject to the contracts that may be settled in cash or shares guidance in paragraph 260-10-45-45. See Question 3.3.10.

Question 6.13A.50
Is a redemption feature in a warrant considered a cash-settlement feature for which the guidance on contracts that may be settled in shares or cash could be applicable?

Background: An instrument may provide for redemption or cash settlement when certain conditions exist. For example, a warrant may be redeemable by the entity if the stock price reaches a specified target for a specified period of time.

Interpretive response: It depends. Such a feature is a contingent cash settlement feature. If the entity is not currently entitled to redeem the instrument for cash, then it is not considered an instrument that can be settled in shares or cash, and the Topic 260 guidance on contracts that may be settled in shares or cash does not apply.

6.18A Equity-classified instruments with a down-round feature

See section 6.18 for guidance on contracts that may be settled in shares or in cash after the adoption of ASU 2020-06.

Excerpt from ASC 260-10

25-1 An entity that presents **earnings per share** (EPS) in accordance with this Topic shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** (that is, instruments that are not convertible instruments) when the down round feature is triggered. That effect shall be treated as a dividend and as a reduction of income available to common stockholders in **basic earnings per share**, in accordance with the guidance in paragraph 260-10-45-12B. See paragraphs 260-10-55-95 through 55-97 for an illustration of this guidance.

30-1 As of the date that a **down round feature** is triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding **financial instrument**, an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)
b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

30-2 The fair values of the financial instruments in paragraph 260-10-30-1 shall be measured in accordance with the guidance in Topic 820 on fair value measurement. See paragraph 260-10-45-12B for related **earnings per share** guidance and paragraphs 505-10-50-3 through 50-3A for related disclosure guidance.

35-1 An entity shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** each time it is triggered but shall not otherwise subsequently remeasure the value of a down round feature that it has recognized and measured in accordance with paragraphs 260-10-25-1 and 260-10-30-1 through 30-2. An entity shall not subsequently amortize the amount in additional paid-in capital arising from recognizing the value of the effect of the down round feature.

• > Freestanding Equity-Classified Financial Instrument with a Down Round Feature

45-12B For a freestanding equity-classified **financial instrument** with a **down round feature**, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

25-1 An entity that presents **earnings per share** (EPS) in accordance with this Topic shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** <u>and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance)</u> ~~(that is, instruments that are not convertible instruments)~~ when the down round feature is triggered. That effect shall be treated as a dividend and as a reduction of income available to common stockholders in **basic earnings per share**, in accordance with the guidance in paragraph 260-10-45-12B. See paragraphs 260-10-55-95 through 55-97 for an illustration of this guidance.

30-1 As of the date that a **down round feature** is triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance), an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)
b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

35-1 An entity shall recognize the value of the effect of a **down round feature** in an equity-classified freestanding **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) each time it is triggered but shall not otherwise subsequently remeasure the value of a down round feature that it has recognized and measured in accordance with paragraphs 260-10-25-1 and 260-10-30-1 through 30-2. An entity shall not subsequently amortize the amount in additional paid-in capital arising from recognizing the value of the effect of the down round feature.

• > Freestanding Equity-Classified Financial Instrument with a Down Round Feature

45-12B For a freestanding equity-classified **financial instrument** and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) with a **down round feature**, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

6.18A.10 Overview of the instrument

A down-round feature is a provision in an equity-linked financial instrument that reduces the strike price of the financial instrument if the entity:

— sells additional common shares for an amount less than the current strike price of the equity-linked instrument; or
— issues an equity-linked instrument with a strike price below the current strike price of the financial instrument.

A down-round feature protects certain investors from a decline in an entity's share price. Although a down-round feature is not normally a significant driver of the fair value of the equity-linked instrument, the instrument's fair value is somewhat greater than a similar equity-linked instrument without a down-round feature.

A down-round feature can take many forms. Specifically, it can:

- reduce the strike price of a financial instrument to the current issuance price;
- limit the reduction in strike price by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares; or
- reduce the strike price to below the current issuance price.

A standard antidilution provision, which is designed to maintain the value of a conversion option if there are adjustments to the conversion ratio of an instrument (e.g. in an equity restructuring transaction), is not considered a down-round feature.

6.18A.20 EPS implications

An entity reflects the effect of a down-round feature of freestanding equity-linked financial instruments (such as warrants) in EPS only if it is triggered. An entity measures the effect of the down-round feature and accounts for it as a deemed dividend when determining income available to common shareholders in basic EPS. [260-10-25-1, 45-12B]

The effect of the down-round feature that is triggered is measured at the trigger date as the difference between the fair value of the freestanding equity-linked financial instrument *without* the down-round feature and the strike price for the instrument immediately: [260-10-30-1]

- **before** the reduction in strike price (i.e. based on the previous strike price); and
- **after** the reduction in strike price (i.e. based on the new strike price).

An entity recognizes the value related to the down-round feature as an increase in additional paid-in capital and a decrease in retained earnings (i.e. as a deemed dividend). This transfer of value reduces net income available to common shareholders. [260-10-45-12B]

The entity does not subsequently amortize the amount to additional paid-in capital. It also does not remeasure the down-round feature, unless the feature is subsequently triggered. [260-10-35-1]

Potential effect on basic EPS	Potential effect on diluted EPS
Numerator X / ✓ Denominator X	Numerator ✓ Denominator ✓

Potential effect on basic EPS	Potential effect on diluted EPS
For equity-classified freestanding financial instruments with a down-round feature, the numerator is adjusted for the value of the down-round feature when it is triggered as a deemed dividend. [260-10-25-1, 45-12B] These instruments are generally not participating securities. Separate disclosure of EPS amounts is required for equity-classified instruments that form a separate class of common shares. [260-10-45-59A – 45-60] Freestanding financial instruments that are classified as liabilities or as derivatives under Topic 815 and are remeasured at fair value each reporting period are not subject to this guidance.	These freestanding financial instruments are potential common shares. The effect of warrants on diluted EPS is described in section 6.9A. The adjustment to the numerator is to add back the numerator adjustment made in the basic EPS calculation. [260-10-55-97] The adjustment to the denominator is based on the additional common shares resulting from the assumed exercise of the instrument, using the treasury stock method. Exercise is assumed to have occurred at the beginning of the period; or the date of issuance of the instrument, if later. [260-10-45-23] For an example of adjustments for options and warrants, see section 6.9A. For examples of adjustments for convertible instruments containing a liability component, see section 6.12A.
Dilutive or antidilutive? As discussed in section 6.9A with regard to options, warrants and their equivalents, whether such an equity-classified instrument is dilutive depends on whether it is in-the-money. Generally, these instruments are dilutive if they are in-the-money – i.e. the exercise price (including the fair value of any goods or services to be supplied to the entity in the future) is lower than the average market price of the common shares. However, these instruments may not be dilutive in the period in which the down-round provision is triggered, because of the numerator adjustment to add back the deemed dividend.	

6.18A.30 Interpretive analysis and examples

Question 6.18A.10

How is a down-round provision different from a variable exercise price?

Interpretive response: A down-round provision is a particular form of a variable price that takes effect only upon a certain specified event – i.e. the issuance of a convertible instrument at an exercise price that is lower than the instrument with the down-round provision. When a down-round provision is exercised, it is treated as a dividend, which affects basic EPS. This is different from a standard exercise price adjustment, which does not affect basic EPS but is taken into account when calculating diluted EPS under the treasury stock method.

Question 6.18A.20

What types of instruments commonly are subject to the down-round features guidance?

Interpretive response: Freestanding equity-classified financial instruments that contain down-round features are subject to the down-round features guidance with respect to basic EPS. The most common instruments subject to this guidance are warrants that are indexed to the issuing entity's own shares and meet the additional conditions necessary for equity classification in Subtopic 815-40. Convertible instruments are not subject to this guidance; instead, they are subject to paragraph 815-10-15-75A with respect to down-round features.

Question 6.18A.30

When calculating basic EPS, does the down-round guidance apply to a warrant with provisions that reduce its strike price and simultaneously increase the number of shares to which warrant holders will be entitled?

Background: A warrant may contain provisions that reduce its strike price and simultaneously increase the number of shares that the warrant holders will be entitled to receive on exercise if the issuer sells common shares for an amount less than the warrant's currently stated strike price or issues an equity-linked financial instrument with a strike price below the warrant's currently stated strike price.

For example, ABC Corp. issues a warrant with the following terms and conditions.

— The original strike price is $10.
— If the issuer sells its common shares for less than $10 per share, the warrant's strike price will be reduced and the number of shares the warrant holder will be entitled to receive will increase based on a formula.
— The formula is designed to adjust the strike price to a level that is less than the original strike price, but greater than the price of the subsequent round of financing – i.e. the strike price adjustment will not cause the warrant to be in- or at-the-money.

The number of shares to which the warrant holder will be entitled will increase by a factor equal to the original strike price divided by the adjusted strike price. Therefore, if the original strike price were to be adjusted to $8, the number of shares to which the warrant holder would be entitled would increase by a factor of 1.25 ($10 ÷ $8).

Interpretive response: The down-round guidance is silent as to any simultaneous adjustment to the number of shares that the warrant holder would be entitled to receive. Based on informal discussions with the SEC staff, we believe the down-round feature guidance with respect to basic EPS applies to a warrant that contains such provisions. Accordingly, the deemed dividend in the period that the down-round feature is triggered should reflect both the change in the strike price and the change in the number of shares issuable.

Question 6.18A.40
How does the entity calculate the effect of the down-round feature?

Interpretive response: When calculating the value of the effect of triggering the down-round feature, an entity determines:

— the fair value of the financial instrument (without the down-round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (i.e. before the strike price reduction); and
— the fair value of the financial instrument (without the down-round feature) with a strike price corresponding to the reduced strike price upon the down-round feature being triggered.

The entity determines these two fair values by applying the fair value measurement guidance in Topic 820; see KPMG Handbook, Fair value measurement. The difference between these two fair values represents the value of the effect of triggering the down-round feature. However, this is not a fair value adjustment of the instrument, but instead a valuation used for determining the value ascribed to the deemed dividend upon triggering a down-round price adjustment.

Question 6.18A.50
Are there any situations in which the value of the effect of triggering the down-round feature is remeasured?

Background: An entity recognizes the value of the effect of triggering a down-round feature in an equity-classified freestanding financial instrument (e.g. a warrant that is indexed to the entity's own shares) upon its trigger.

Interpretive response: No. When a down-round feature is triggered, the value of the effect of triggering the feature is recognized and measured under paragraphs 260-10-25-1 and 260-10-30-1 to 30-2. The value related to this triggering is not subsequently remeasured. However, the value of the effect of any subsequent triggering of that feature would also be recognized and measured under paragraphs 260-10-25-1 and 260-10-30-1 to 30-2.

Question 6.18A.60

How are potential common shares included in diluted EPS for a convertible instrument with both a market price trigger and a down-round feature?

Background: ABC Corp. issues 1,000 Series A convertible bonds, with a par value of $100 each and a conversion price of $120. The bonds are convertible only when ABC's stock price reaches $110 (the market price trigger). According to the terms of the convertible bond, if ABC subsequently issues convertible bonds at a lower conversion price, the conversion price of the Series A convertible bonds will be reduced accordingly (the down-round feature).

Interpretive response: ABC first considers *whether* the convertible bonds are included in diluted EPS, and then considers *how* to include them. When there is a market price contingency, the convertible bonds are still considered for inclusion in diluted EPS (see section 6.12A). [260-10-45-44, 260-10-45-52]

Therefore, in the background example, ABC ignores the market price contingency and includes the convertible bonds in its diluted EPS calculations. However, due to the down-round feature, ABC follows the guidance on contingently issuable shares (see section 6.10) to determine how to include the convertible bonds in diluted EPS. ABC does not consider the effect of the down-round feature until it is actually triggered. Therefore, ABC uses the conversion price in effect at period end, following the guidance for contingently issuable shares with a market price contingency, to determine the number of potentially dilutive shares to include in diluted EPS. See also the flowchart at section 4.3. [260-10-45-44, 260-10-45-52]

Example 6.18A.10

Warrants that contain a down-round feature

ABC Corp. has 3,000,000 common shares outstanding. On January 1, Year 1, ABC issues 100,000 warrants that contain a down-round feature.

The following facts are relevant.

— The warrants have a 10-year term and permit the holders to buy common shares for $10 per share and are exercisable at any time.

— Each warrant can be exercised in exchange for five common shares.

- The warrants specify that if ABC issues additional common shares for an amount less than $10 per share or issues equity-linked financial instruments with a strike price below $10 per share, the strike price of the warrants will be reduced to the issuance price of such common shares or the strike price of the equity-linked financial instruments.
- ABC classifies the warrants as equity because they do not meet the definition of a derivative in paragraph 815-10-15-83 but they do meet the conditions for the equity scope exception in paragraph 815-10-15-74(a); the down-round feature is ignored for these determinations.
- ABC has no other potential common shares.
- Net income is $4,600,000 in Year 1.

ABC issues 200,000 common shares at $8 per share on the first day of its third quarter of its fiscal year. Because this subsequent round of financing occurs at a share price below the original strike price of the warrants ($10), the down-round feature is triggered, and the strike price of the warrants is reduced to $8 per share.

- The value of the effect of triggering the down-round feature is $700,000 and is calculated under paragraph 260-10-30-1.
- The average market price of ABC's common shares during Q3 of Year 1 is $9.00 per share.

EPS calculations – Year 1

Because the warrants are equity-classified freestanding financial instruments, the value of triggering the down-round feature is treated as a deemed dividend and deducted from income available to common shareholders upon the date the feature is triggered when calculating basic EPS. That value is added back for the purposes of calculating diluted EPS.

Step	Basic EPS	Step	Diluted EPS
1	**Determine the numerator** The numerator is adjusted for the value of the down-round feature that is treated as a deemed dividend. ABC calculates the numerator as follows: $4,600,000 – 700,000 = $3,900,000.	1	**Identify potential common shares** Options are exercisable for more than little consideration and are therefore potential common shares for the period during which they are outstanding.
2	**Determine the denominator** No adjustment is necessary until the warrants are exercised and common shares are issued, because they are exercisable for more than little consideration. There is a change in the number of outstanding shares during the year for the 200,000 issued on October 1.	2	**For each potential common share, calculate EPIS** *Potential adjustment to the numerator for EPIS:* The adjustment for the triggering of the down-round feature included in basic EPS is added back in the diluted calculation. $3,900,000 + $700,000 = $4,600,000

Step	Basic EPS

ABC calculates the denominator as follows.

	Number of shares	Time weight.	Weighted average
Common shares outstanding **Jan. – Sept.**	3,000,000	9/12	2,250,000
Oct 1 – issuance of shares	200,000		
Oct. – Dec.	3,200,000	3/12	800,000
		12/12	
Weighted average for the year			**3,050,000**

Therefore, the denominator is 3,050,000.

Step	Diluted EPS

Potential adjustment to the denominator for EPIS: The adjustment is determined using the treasury stock method (see section 6.9A.30), as follows.

Step i	Weighted-average number of warrants (and shares to be issued on exercise of warrants)[1]	500,000	(A)
	Exercise price	$8.00	(B)
	Assumed proceeds[2]	$4,000,000	(C) = (A) × (B)
Step ii	Average market price of common shares	$9.00	(D)
	Number of common shares deemed issued	444,444	(E) = (C) ÷ (D)
Step iii	**Incremental shares**	55,555	(A) – (E)

Notes:

1. 100,000 × 50 = 500,000
2. Assumed proceeds of 100,000 warrants at $8.00 exercise price × 5 shares = $4,000,000

EPIS is therefore $700,000 ÷ 55,555 = $12.60

3 Rank the potential common shares

This step does not apply because the warrants are the only class of potential common shares.

4 Determine basic EPS from continuing operations

Basic EPS is $1.28 (see Step 3 of basic EPS calculation).

Step	Basic EPS	Step	Diluted EPS
3	**Determine basic EPS** Basic EPS = $3,900,000 ÷ 3,050,000 = $1.28	5	**Identify dilutive potential common shares and determine diluted EPS** The potential effect of the options is determined as follows.

	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	$3,900,000	3,050,000	$1.28	
Warrants	700,000	55,555		
Total	**$4,600,000**	**3,105,000**	$1.48	✗

As the warrants are antidilutive, their effect is not included in diluted EPS.

Diluted EPS = $1.28

The following additional example is presented in Topic 260.

Excerpt from ASC 260-10

• > Example 16: Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature

55-95 Assume Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share and that Entity A presents EPS in accordance with the guidance in this Topic. The warrants have a 10-year term, are exercisable at any time, and contain a **down round feature**. The warrants are classified as equity by Entity A because they are indexed to the entity's own stock and meet the additional conditions necessary for equity classification in accordance with the guidance in Subtopic 815-40 on derivatives and hedging—contracts in entity's own equity (see paragraphs 815-40-55-33 through 55-34A for an illustration of the guidance in Subtopic 815-40 applied to a warrant with a down round feature). Because the warrants are an equity-classified freestanding **financial instrument**, they are within the scope of the recognition and measurement guidance in this Topic. The terms of the down round feature specify that if Entity A issues additional shares of its common stock for an amount less than $10 per share or issues an equity-classified financial instrument with a strike price below $10 per share, the strike price of the warrants would be reduced to the most recent issuance price or strike price, but the terms of the down round feature are such that the strike price cannot be reduced below $8 per share. After issuing the warrants, Entity A issues shares of its common stock at $7 per share. Because of the subsequent round of financing occurring at a share price below the strike price of the warrants, the down round feature in the warrants is triggered and the strike price of the warrants is reduced to $8 per share.

55-96 In accordance with the measurement guidance in paragraphs 260-10-30-1 through 30-2, Entity A determines that the fair value of the warrants (without the down round feature) with a strike price of $10 per share immediately after the down round feature is triggered is $600 and that the fair value of the warrants (without the down round feature) with a strike price of $8 per share immediately after the down round feature is triggered is $750. The increase in the value of $150 is the value of the effect of the triggering of the down round feature.

55-97 The $150 increase is the value of the effect of the down round feature to be recognized in equity in accordance with paragraph 260-10-25-1, as follows:

Retained earnings	$150	
Additional paid-in capital		$150

Additionally, Entity A reduces income available to common stockholders in its basic EPS calculation by $150 in accordance with the guidance in paragraph 260-10-45-12B. Entity A applies the treasury stock method in accordance with paragraphs 260-10-45-23 through 45-27 to calculate diluted EPS. Accordingly, the $150 is added back to income available to common stockholders when calculating diluted EPS. However, the treasury stock method would not be applied if the effect were to be antidilutive.

8.3A EPS calculations

8.3A.20 Quarterly EPS calculation

Excerpt from ASC 260-10

• • > Year-to-Date Computations

55-3 The number of incremental shares included in quarterly diluted EPS shall be computed using the average market prices during the three months included in the reporting period…

When calculating EPS in an interim period, the quarterly calculation is based on the weighted-average number of shares outstanding during the quarter. This does not affect basic EPS calculations because the calculation is based on the actual weighted-average number of shares outstanding. However, for diluted EPS calculations, which includes dilutive potential common shares, conversion, exercise or settlement of these shares is considered to take place as of the beginning of the quarter; or from the date the instrument is outstanding, if later.

Topic 260 indicates that dilutive shares are determined independently for each period presented. Therefore, an entity does not retrospectively adjust the diluted EPS of any prior period presented for changes in the assumptions used in the calculation or for the conversion of potential common shares into common shares – e.g. when a convertible instrument is dilutive in one period but not in the another. [260-10-55-3]

8.3A.30 Year-to-date EPS calculation

Excerpt from ASC 260-10

• > Applying the Treasury Stock Method

• • > Year-to-Date Computations

55-3 The number of incremental shares included in quarterly diluted EPS shall be computed using the average market prices during the three months included in the reporting period. For year-to-date diluted EPS, the number of incremental shares to be included in the denominator shall be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation. Example 1 (see paragraph 260-10-55-38) provides an illustration of that provision.

55-3A Computation of year-to-date diluted EPS when an entity has a year-to-date loss from continuing operations including one or more quarters with income from continuing operations and when in-the-money options or warrants were not included in one or more quarterly diluted EPS computations because there was a loss from continuing operations in those quarters is as follows. In computing year-to-date diluted EPS, year-to-date income (or loss) from continuing operations shall be the basis for determining whether or not dilutive potential common shares not included in one or more quarterly computations of diluted EPS shall be included in the year-to-date computation.

55-3B Therefore:

a. When there is a year-to-date loss, potential common shares should never be included in the computation of diluted EPS, because to do so would be antidilutive.
b. When there is year-to-date income, if in-the-money options or warrants were excluded from one or more quarterly diluted EPS computations because the effect was antidilutive (there was a loss from continuing operations in those periods), then those options or warrants should be included in the diluted EPS denominator (on a weighted-average basis) in the year-to-date computation as long as the effect is not antidilutive. Similarly, contingent shares that were excluded from a quarterly computation solely because there was a loss from continuing operations should be included in the year-to-date computation unless the effect is antidilutive.

Example 12 (see paragraph 260-10-55-85) illustrates this guidance.

• > Contingently Issuable Shares

45-49 For year-to-date computations, contingent shares shall be included on a weighted-average basis. That is, contingent shares shall be weighted for the interim periods in which they were included in the computation of diluted EPS.

• > Contracts That May Be Settled in Stock or Cash

55-34 Year-to-date diluted EPS calculations may require an adjustment to the numerator in certain circumstances. For example, for contracts in which the counterparty controls the method of settlement and that would have a more dilutive effect if settled in shares, the numerator adjustment is equal to the earnings effect of the change in the fair value of the asset or liability recorded pursuant to Section 815-40-35 during the year-to-date period. In that example, the number of incremental shares included in the denominator should be determined by calculating the number of shares that would be required to settle the contract using the average share price during the year-to-date period.

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

• > Contracts That May Be Settled in Stock or Cash

55-34 Year-to-date diluted EPS calculations may require an adjustment to the numerator in certain circumstances. For example, for contracts that are share settled for EPS purposes ~~in which the counterparty controls the method of settlement and that would have a more dilutive effect if settled in shares~~, the numerator adjustment is equal to the earnings effect of the change in the fair value of the asset or liability recorded pursuant to Section 815-40-35 during the year-to-date period. In that example, the number of incremental shares included in the denominator should be determined in accordance with the guidance in paragraph 55-3 ~~by calculating the number of shares that would be required to settle the contract using the average share price during the year-to-date period~~.

Select Topic 260 illustrations

Excerpt from ASC 260-10

• > Example 11: Computation of Basic and Diluted EPS for Two Examples of Contingently Convertible Instruments

55-78 The following Cases illustrate the guidance in paragraphs 260-10-45-43 through 45-44 related to diluted EPS computations for two examples of contingently convertible instruments:

a. Contingently convertible debt with a market price trigger (Case A)
b. Contingently convertible debt with a market price trigger, issuer must settle the principal amount of the debt in cash, but may settle any conversion premium in either cash or stock (Case B).

55-79 Cases A and B share all of the following assumptions:

a. Principal amount of the convertible debt: $1,000
b. Conversion ratio: 20
c. Conversion price per share of common stock: $50 Conversion price = (Convertible bond's principal amount) ÷ (Conversion ratio) = $1,000 ÷ 20 = $50.
d. Share price of common stock at issuance: $40
e. Market price trigger: average share price for the year must exceed $65 (130% of conversion price)

f. Interest rate: 4%
g. Effective tax rate: 35%
h. Shares of common stock outstanding: 2,000.

• • > Case A: Contingently Convertible Debt with a Market Price Trigger

55-81 The holder of the debt may convert the debt into shares of common stock when the share price exceeds the market price trigger; otherwise, the holder is only entitled to the par value of the debt.

55-82 The contingently convertible debt is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X, is $10,000, and the average share price for the year is $55. The issuer of the contingently convertible debt should apply the consensus in this Issue, which requires the issuer to include the dilutive effect of the convertible debt in diluted EPS even though the market price trigger of $65 has not been met. In this Case, basic EPS is $5.00. (Basic EPS = [Income available to common shareholders (IACS)] ÷ [Shares outstanding (SO)] = $10,000 ÷ 2,000 shares = $5.00 per share) and applying the if-converted method to the debt instrument dilutes EPS to $4.96 (Diluted EPS computed using the if-converted method = [IACS + Interest (1-tax rate)] ÷ (SO + Potential common shares) = ($10,000 + $26) ÷ (2,000 + 20) shares = $4.96 per share.)

• • > Case B: Contingently Convertible Debt with a Market Price Trigger, Issuer Must Settle Principal in Cash, but May Settle Conversion Premium in either Cash or Stock

55-84 The issuer of the contingently convertible debt must settle the principal amount of the debt in cash upon conversion and it may settle any conversion premium in either cash or stock. The holder of the instrument is only entitled to the conversion premium if the share price exceeds the market price trigger. The contingently convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X is $9,980, and the average share price for the year is $64.

55-84A The if-converted method should not be used to determine the earnings-per-share implications of convertible debt with the characteristics described in this Case. There would be no adjustment to the numerator in the diluted earnings-per-share computation for the cash-settled portion of the instrument because that portion will always be settled in cash. The conversion premium should be included in diluted earnings per share based on the provisions of paragraphs 260-10-45-45 through 45-46 and 260-10-55-32 through 55-36. The convertible debt instrument in this Case is subject to other applicable guidance in Subtopic 260-10 as well, including the antidilution provisions of that Subtopic.

55-84B In this example, basic EPS is $4.99, and diluted earnings per share is $4.98.Basic EPS = IACS ÷ SO = $9,980 ÷ 2,000 shares = $4.99 per share. Diluted EPS = IACS ÷ (SO + Potential common shares) = ($9,980) ÷ (2,000 + 4.38) shares = $4.98 per share. Potential common shares = (Conversion spread value) ÷ (Average share price) = $14 × 20 shares ÷ $64 = 4.38 shares.

Pending Content

Transition Date: (P) December 16, 2021; (N) December 16, 2023 ¦ Transition Guidance: 815-40-65-1

• > Example 11: Computation of Basic and Diluted EPS for ~~Two~~ Three Examples of Contingently Convertible Instruments

55-78 The following Cases illustrate the guidance in paragraphs 260-10-45-43 through ~~45-44~~ 45-46 related to diluted EPS computations for ~~two~~ three examples of contingently convertible instruments:

a. Contingently convertible debt with a market price trigger (Case A)
b. Contingently convertible debt with a market price trigger, issuer must settle the principal amount of the debt in cash, but may settle any conversion premium in either cash or stock (Case B).
c. Convertible debt for which the principal and conversion premium can be settled in any combination of shares or cash (Case C).

55-79 Cases ~~A and B~~ A, B and C share all of the following assumptions:

a. Principal amount of the convertible debt: $1,000
b. Conversion ratio: 20
c. Conversion price per share of common stock: $50 Conversion price = (Convertible bond's principal amount) ÷ (Conversion ratio) = $1,000 ÷ 20 = $50.
d. Share price of common stock at issuance: $40
e. Market price trigger: average share price for the year must exceed $65 (130% of conversion price)
f. Interest rate: 4%
g. Effective tax rate: 35%
h. Shares of common stock outstanding: 2,000.

• • > Case A: Contingently Convertible Debt with a Market Price Trigger

55-81 The holder of the debt may convert the debt into shares of common stock when the share price exceeds the market price trigger; otherwise, the holder is only entitled to the par value of the debt.

55-82 The contingently convertible debt is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X, is $10,000, and the average share price for the year is $55. The issuer of the contingently convertible debt should apply the guidance in paragraphs 260-10-45-43 through 45-44 ~~consensus in this Issue~~, which requires the issuer to include the dilutive effect of the convertible debt in diluted EPS even though the market price trigger of $65 has not been met. In this Case, basic EPS is $5.00. (Basic EPS = [Income available to common shareholders (IACS)] ÷ [Shares outstanding (SO)] = $10,000 ÷ 2,000 shares = $5.00 per share) and applying the if-converted method to the debt instrument dilutes EPS to $4.96 (Diluted EPS computed using the if-converted method = [IACS + Interest (1-tax rate)] ÷ (SO + Potential common shares) = ($10,000 + $26) ÷ (2,000 + 20) shares = $4.96 per share.)

• • > Case B: Contingently Convertible Debt with a Market Price Trigger, Issuer Must Settle Principal in Cash, but May Settle Conversion Premium in either Cash or Stock

55-84 The issuer of the contingently convertible debt must settle the principal amount of the debt in cash upon conversion and it may settle any conversion premium in either cash or stock. The holder of the instrument is only entitled to the conversion premium if the share price exceeds the market price trigger. The contingently convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X is $9,980, and the average share price for the year is $64.

55-84A The if-converted method should ~~not~~ be used to determine the earnings-per-share implications of convertible debt with the characteristics described in this Case. There would be no adjustment to the numerator in the diluted earnings-per-share computation for the cash-settled portion of the instrument (the principal amount of the debt) because that portion will always be settled in cash (see paragraph 260-10-45-40). The conversion premium should be included in diluted earnings per share based on the provisions of paragraphs 260-10-45-45 through 45-46 and 260-10-55-32 through 55-36A ~~55-36~~. The convertible debt instrument in this Case is subject to other applicable guidance in Subtopic 260-10 as well, including the antidilution provisions of that Subtopic.

55-84B In this example, basic EPS is $4.99, and diluted earnings per share is $4.98.Basic EPS = IACS ÷ SO = $9,980 ÷ 2,000 shares = $4.99 per share. Diluted EPS would be calculated using the if-converted method by determining the number of shares needed to settle the conversion premium and adding that amount to shares outstanding to calculate the diluted EPS denominator. The average market price is used to determine the dilution in accordance with paragraph 260-10-45-21A. The effect would be dilutive in this case because the average market price of the shares exceeds the conversion price. However, if the average market price of the shares was less than the conversion price, then the conversion premium would be zero and there would be no dilutive effect. Diluted EPS = IACS ÷ (SO + Potential common shares) = ($9,980) ÷ (2,000 + 4.38) shares = $4.98 per share. Potential common shares = (Conversion spread value) ÷ (Average share price) = $14 × 20 shares ÷ $64 = 4.38 shares.

• • > Case C: Convertible Debt That the Principal and Conversion Premium Can Be Settled in Any Combination of Shares or Cash

55-84C The issuer of the convertible debt can settle the principal and the conversion premium in any combination of cash or shares (the issuer has the option). Consistent with the facts in Case B, the convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X, is $9,980, and the average share price for the year is $64.

55-84D The if-converted method should be used to determine the earnings-per-share implications of convertible debt. The effect of settling the principal and conversion premium in shares is included for purposes of calculating diluted earnings per share in accordance with the guidance in paragraph 260-10-45-45.

55-84E In this case, basic EPS is $4.99 (the same calculation in paragraph 260-10-55-84B), and diluted earnings per share is $4.95. Diluted EPS is calculated using the if-converted method = [IACS + Interest (1-tax rate)] ÷ (SO + Potential common shares) = (9,980 + 26) ÷ (2,000 + 20). See paragraph 260-10-55-82 for interest expense amount.

B. Topic 260 Glossary

Excerpt from ASC 260-10

20 Glossary

Antidilution

An increase in earnings per share amounts or a decrease in loss per share amounts.

Basic Earnings Per Share

The amount of earnings for the period available to each share of common stock outstanding during the reporting period.

Call Option

A contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period. See **Option** and **Purchased Call Option**.

Common Stock

A stock that is subordinate to all other stock of the issuer. Also called common shares.

Consolidated Financial Statements

The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity.

Consolidated Group

A parent and all its subsidiaries.

Contingent Issuance

A possible issuance of shares of common stock that is dependent on the satisfaction of certain conditions.

Contingent Stock Agreement

An agreement to issue common stock (usually in connection with a business combination) that is dependent on the satisfaction of certain conditions. See **Contingently Issuable Shares**.

Contingently Convertible Instruments

Contingently convertible instruments are instruments that have embedded conversion features that are contingently convertible or exercisable based on either of the following:

a. A market price trigger
b. Multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition.

A market price trigger is a market condition that is based at least in part on the issuer's own share price. Examples of contingently convertible instruments include contingently convertible debt, contingently convertible preferred stock, and the instrument described by paragraph 260-10-45-43, all with embedded market price triggers.

Contingently Issuable Shares

Shares issuable for little or no cash consideration upon the satisfaction of certain conditions pursuant to a contingent stock agreement. Also called contingently issuable stock. See **Contingent Stock Agreement**.

Conversion Rate

The ratio of the number of common shares issuable upon conversion to a unit of a convertible security. For example, $100 face value of debt convertible into 5 shares of common stock would have a conversion ratio of 5:1. Also called conversion ratio.

Convertible Security

A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

Diluted Earnings Per Share

The amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period.

Dilution

A reduction in EPS resulting from the assumption that convertible securities were converted, that options or warrants were exercised, or that other shares were issued upon the satisfaction of certain conditions.

Down Round Feature

Note: The following definition is Pending Content; see Transition Guidance in 260-10-65-4.

A feature in a **financial instrument** that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A **standard antidilution provision** is not considered a down round feature.

Dropdown

A transfer of certain net assets from a sponsor or general partner to a master limited partnership in exchange for consideration.

Earnings Per Share

The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

Employee Stock Ownership Plan

An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.

Equity Restructuring

A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

Exercise Price

The amount that must be paid for a share of common stock upon exercise of an option or warrant.

Financial Instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:
    1. To deliver cash or another financial instrument to a second entity
    2. To exchange other financial instruments on potentially unfavorable terms with the second entity.
b. Conveys to that second entity a contractual right either:
    1. To receive cash or another financial instrument from the first entity
    2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

If-Converted Method

A method of computing EPS data that assumes conversion of convertible securities at the beginning of the reporting period (or at time of issuance, if later).

Income Available to Common Stockholders

Income (or loss) from continuing operations or net income (or net loss) adjusted for preferred stock dividends.

Noncontrolling Interest

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Option

Unless otherwise stated, a call option that gives the holder the right to purchase shares of common stock from the reporting entity in accordance with an agreement upon payment of a specified amount. Options include, but are not limited to, options granted to employees and stock purchase agreements entered into with employees. Options are considered securities. See **Call Option**.

Note: The following definition is Pending Content; see Transition Guidance in 718-10-65-11.

Unless otherwise stated, a call option that gives the holder the right to purchase shares of common stock from the reporting entity in accordance with an agreement upon payment of a specified amount. Options include, but are not limited to, options granted and stock purchase agreements entered into with grantees. Options are considered securities. See **Call Option**.

Participating Security

A **security** that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.

Potential Common Stock

A security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period.

Preferred Stock

A security that has preferential rights compared to common stock.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Purchased Call Option

A contract that allows the reporting entity to buy a specified quantity of its own stock from the writer of the contract at a fixed price for a given period. See **Call Option**.

Put Option

A contract that allows the holder to sell a specified quantity of stock to the writer of the contract at a fixed price during a given period.

Reverse Treasury Stock Method

A method of recognizing the dilutive effect on EPS of satisfying a put obligation. It assumes that the proceeds used to buy back common stock (pursuant to the terms of a put option) will be raised from issuing shares at the average market price during the period. See **Put Option**.

Rights Issue

An offer to existing shareholders to purchase additional shares of common stock in accordance with an agreement for a specified amount (which is generally substantially less than the fair value of the shares) for a given period.

Security

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Security

The evidence of debt or ownership or a related right. It includes options and warrants as well as debt and stock.

Share-Based Payment Arrangements

An arrangement under which either of the following conditions is met:

a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.
b. The entity incurs liabilities to suppliers that meet either of the following conditions:
    1. The amounts are based, at least in part, on the price of the entity’s shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity’s shares and something other than either the price of the entity’s shares or a market, performance, or service condition.)
    2. The awards require or may require settlement by issuance of the entity’s shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity.

Also called share-based compensation arrangements.

Standard Antidilution Provisions

Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an **equity restructuring** transaction that are designed to maintain the value of the conversion option.

Stock Dividend

An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property that the board of directors deems necessary or desirable to retain in the business. A stock dividend takes nothing from the property of the corporation and adds nothing to the interests of the stockholders; that is, the corporation's property is not diminished and the interests of the stockholders are not increased. The proportional interest of each shareholder remains the same.

Subsidiary

An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

Treasury Stock Method

A method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds would be used to purchase common stock at the average market price during the period.

Warrant

A security that gives the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount.

Weighted-Average Number of Common Shares Outstanding

The number of shares determined by relating the portion of time within a reporting period that common shares have been outstanding to the total time in that period. In computing diluted EPS, equivalent common shares are considered for all dilutive potential common shares.

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with ** and items that have been significantly updated or revised are identified with #.

3. Basic EPS – The foundations

3.4.30 Should these shares be included?

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Questions

3.3.112 How does a down-round feature in an equity-classified instrument affect EPS? **

3.3.119 How does NCI in the form of a subsidiary's redeemable common shares affect the parent's EPS? **

3.3.120 How does NCI in the form of a subsidiary's redeemable preferred shares affect the parent's EPS? #

4. Diluted EPS – The foundations

4.3 Step 1: Identify potential common shares

Observation

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4.4.30 Numerator adjustment #

4.4.40 Denominator adjustment, including the treasury stock method

Observation

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Question

4.3.10 How are mandatorily convertible instruments considered for diluted EPS? #

5. Participating securities and the two-class method

Example

5.7.05 Basic and diluted EPS calculations for an entity with two classes of common shares **

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