Financial reporting developments

*A comprehensive guide*

# Earnings per share

September 2024

EY

Building a better working world

# To our clients and other friends

We are pleased to provide you with the latest edition of our Financial reporting developments (FRD) publication on earnings per share (EPS).

The Financial Accounting Standards Board (FASB or Board) guidance on earnings per share is codified in Accounting Standards Codification (ASC or Codification) 260, *Earnings Per Share*. This publication is designed to provide detailed interpretative guidance on the rules related to the calculation and disclosure of EPS. This publication includes excerpts from and references to ASC 260 and other Codification topics, interpretive guidance and examples. It also provides insights from the Securities and Exchange Commission (SEC or Commission) staff.

This edition addresses the effects of the guidance in Accounting Standards Update (ASU) 2020-06 on EPS. The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021 and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023 and interim periods therein.

ASU 2020-06 simplified an issuer's accounting for convertible instruments and its application of the equity classification guidance. The guidance modified the if-converted method of calculating diluted EPS and requires entities to use this method for all convertible instruments. For instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, the guidance requires entities to include the effect of potential share settlement in the diluted EPS calculation (if the effect is more dilutive). In addition, the ASU expanded the scope of the recognition and measurement guidance in ASC 260 to include equity-classified convertible preferred stock that includes a down round feature.

We hope this publication will help you understand and apply the accounting and disclosure guidance for EPS. EY professionals are prepared to assist you in your understanding and are ready to discuss your particular concerns and questions.

September 2024

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

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# 1 Overview

## 1.1 Basic EPS

As further discussed in section 3, basic EPS, one of the two measures of EPS required to be disclosed by ASC 260, is calculated by dividing income available to common stockholders (i.e., net income or loss attributable to the parent entity adjusted for preferred stock dividends declared or accumulated, income attributable to noncontrolling interests, and other relevant adjustments) by the weighted average number of common shares outstanding. Options, warrants, nonvested share-based payment awards and convertible securities are excluded from the basic EPS calculation. Contingently issuable shares (i.e., shares issuable for little or no cash consideration upon the satisfaction of certain conditions) are included in basic EPS only if all the necessary conditions for the issuance of such shares have been satisfied by the end of the period (e.g., the issuance of shares is no longer contingent on any conditions except for the passage of time).

## 1.2 Diluted EPS

As further discussed in section 4, diluted EPS is the second EPS measure required to be disclosed by ASC 260. In computing diluted EPS, basic EPS is adjusted for the assumed issuance of potential common shares that were dilutive and outstanding during the period. To determine whether a potential common share is dilutive, entities are required to apply the antidilution sequencing guidance in ASC 260.

The dilutive effect of call options, warrants and share-based payment awards is calculated using the treasury stock method, which assumes that the proceeds from the exercise of these instruments are used to purchase common shares at the average market price for the period. The dilutive effect of convertible debt and preferred stock is generally calculated using the if-converted method. Under the if-converted method, securities are assumed to be converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares are included in the denominator of the diluted EPS calculation for the period that they were outstanding. Interest (including the effect of accretion of discounts or amortization of premiums, as well as amortization of debt issuance costs), net of any income tax effects, and dividends on convertible securities are generally added back to the numerator for purposes of the if-converted calculation. In addition, the numerator is adjusted for the after-tax effects of any nondiscretionary adjustments based on income that would have been computed differently had interest or dividends not been recognized, such as expense resulting from profit-sharing plans.

Diluted EPS also includes certain shares that are contingently issuable. Contingently issuable shares are included in the denominator for the entire period if all necessary conditions have been satisfied by the end of the period (i.e., the contingent events have occurred). 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 as of the end of the reporting period using an assumption that the end of the reporting period was also the end of the contingency period (and the result would be dilutive). For example, if attainment or maintenance of a specified level of income is the condition for issuance and that level is met as of the end of the reporting period, the contingently issuable shares should be included in the diluted calculation (provided they are dilutive). That is, the diluted EPS computation should 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. The calculation should not reflect further dilution that could arise if a higher level of earnings was achieved and additional shares would become issuable. For diluted EPS purposes, performance-based stock options and other awards are considered contingently issuable, but awards subject only to service vesting are not.

After the adoption of ASU 2020-06, for instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, the amendments to ASC 260 require entities to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement, or the entity has a history or policy of cash settlement. Contracts that may be settled in cash or shares and are 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.

Only securities that are dilutive are included in the calculation of diluted EPS. Entities reporting discontinued operations are required to use income from continuing operations (attributable to the parent entity) as the "control number" or benchmark to determine whether potential common shares are dilutive or antidilutive.

## 1.3 Participating securities and the two-class method

As further discussed in section 5, entities that have multiple classes of common stock or have issued securities other than common stock that participate in dividends with the common stock (i.e., participating securities) are required to apply the two-class method to compute EPS. Examples of participating securities include preferred stock that receives dividends based on dividends paid on common stock and nonvested share-based payment awards that contain rights to receive nonforfeitable dividends. The two-class method is an earnings allocation method under which EPS is calculated for each class of common stock and participating security considering both dividends declared (or accumulated) and participation rights in undistributed earnings as if all such earnings had been distributed during the period. Such allocation can result in a substantial reduction in both basic and diluted EPS.

ASC 260 only requires disclosure in the financial statements of basic and diluted EPS under the two-class method for each class of common stock. That is, although basic and diluted EPS would be calculated for multiple classes of common stock and each participating security, disclosure in the financial statements is only required for classes of common stock. Disclosure of the basic and diluted EPS amounts for a participating security is permitted but not required.

## 1.4 Presentation and disclosure

As further discussed in section 7, EPS must be presented for each period a statement of operations is presented. Entities with simple capital structures (i.e., no potentially dilutive securities) are required to present basic per-share amounts for both income from continuing operations attributable to the parent entity and net income attributable to the parent entity on the face of the statement of operations. Entities with complex capital structures are required to present both basic and diluted per-share amounts for income from continuing operations attributable to the parent entity and net income attributable to the parent entity on the face of the statement of operations. If diluted EPS is presented for any period, it must be presented for all periods even if it is the same amount as basic EPS. The terms "basic" and "diluted" are not required to be used. Other terms, such as "earnings per common share" and "earnings per share — assuming dilution," may be used.

Entities that report discontinued operations must present basic and diluted per-share amounts for those line items either on the face of the statement of operations or in the notes to the financial statements. Given the emphasis placed on EPS information by financial statement users, we recommend that such information be presented on the face of the statement of operations.

For each period a statement of operations is presented, the following disclosures, among others, are required:

- A reconciliation of the numerators (earnings) and denominators (shares) of the basic and diluted per-share computations for income from continuing operations. The reconciliation should include the individual income and share effects of all securities that affect EPS.

- The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
- Securities (including those issuable pursuant to contingent stock agreements) that potentially could 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 periods presented (e.g., "out-of-the-money" options).

For the latest period in which a statement of operations is presented, an entity must describe any transaction that occurs after the end of the most recent reporting period but before issuance of the financial statements that would have materially changed 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 reporting period.

SEC registrants are subject to incremental disclosures required by the Commission's rules and guidance (e.g., Regulation S-X, SAB Topics). In some situations, entities are also required by GAAP or SEC rules to disclose pro forma EPS amounts.

## 1.5 Recent standard setting (updated August 2023)

### ASU 2020-06

The FASB issued ASU 2020-06 in August 2020 to simplify an issuer's accounting for convertible instruments and application of the equity classification guidance. The ASU also amended ASC 260 to simplify and improve the consistency of the diluted EPS calculation. As discussed in further detail throughout this publication, among other things, the guidance modified the if-converted method of calculating diluted EPS and requires entities to use this method for all convertible instruments. For instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, the guidance requires entities to include the effect of potential share settlement in the diluted EPS calculation (if the effect is more dilutive). In addition, the ASU expanded the scope of the recognition and measurement guidance in ASC 260 to include equity-classified convertible preferred stock that includes a down round feature.

ASU 2020-06 was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

The ASU allows entities to use either a modified retrospective or full retrospective transition method. Under the modified retrospective approach, entities apply the guidance to all financial instruments that are outstanding as of the beginning of the year of adoption. Under this method, EPS amounts are not restated in prior periods presented. Under the full retrospective method, entities apply the guidance to all financial instruments that are outstanding as of the beginning of the first comparative reporting period for each prior reporting period presented in accordance with the guidance on accounting changes in ASC 250-10-45-5 through 45-10.

Entities must disclose the following in each interim and annual period of the fiscal year in which the entity adopts ASU 2020-06 (ASC 815-40-65-1(e) and (g)):

- The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
- The method of applying the change
- The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the ASU is initially applied
- The effect of the change on per-share amounts for the period of adoption if they present EPS

Under the full retrospective method, as required by ASC 815-40-65-1(f), entities also need to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line item and per-share amounts for the current period and any prior periods that are adjusted.

Because entities are required to disclose, in the interim and annual periods of adoption, the per-share effects of the adoption of ASU 2020-06, they will effectively be required to calculate diluted EPS under ASC 260 before the adoption of ASU 2020-06 and after.

# 2 Scope and scope exceptions

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Scope and Scope Exceptions*

*General*

*260-10-15-1*

The Scope Section of the Overall Subtopic establishes the pervasive scope for the **Earnings per Share** Topic.

*260-10-15-2*

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.

*260-10-15-3*

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.

EPS must be presented for all entities that have issued common stock or potential common stock (e.g., options, warrants, convertible securities, contingent stock agreements) if those securities trade publicly either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally. EPS also must be presented by an entity that has made or is in the process of making a filing with a regulatory agency in preparation for the sale of securities in a public market.

That is, the scope of ASC 260 excludes nonpublic entities and entities whose publicly traded securities only include nonconvertible debt. EPS presentation is also not required for investment companies in the scope of ASC 946. However, an entity that is not required to present EPS, but does so voluntarily, should present EPS in accordance with the guidance in ASC 260.

## 2.1 Securities that are similar to common stock

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

***Common Stock***

A stock that is subordinate to all other stock of the issuer. Also called common shares.

ASC 260 requires presentation of EPS for each class of common stock. Some entities may have an equity structure that includes only preferred shares or preferred shares with terms that are substantially the same as common stock. Additionally, certain pass-through entities may have equity interests that are similar to common stock but are not labeled as such. Because it may not be apparent from the form (e.g., legal name) whether securities meet the definition of common stock, all securities should be carefully evaluated to determine whether they have the characteristics of common shares (e.g., whether they are subordinate to other classes of stock) and are considered common stock for EPS purposes.

# 3 Basic EPS

## 3.1 Computation of basic EPS

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Objectives*

*Basic EPS*

*260-10-10-1*

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

*Other Presentation Matters*

*Computation of Basic EPS*

*260-10-45-10*

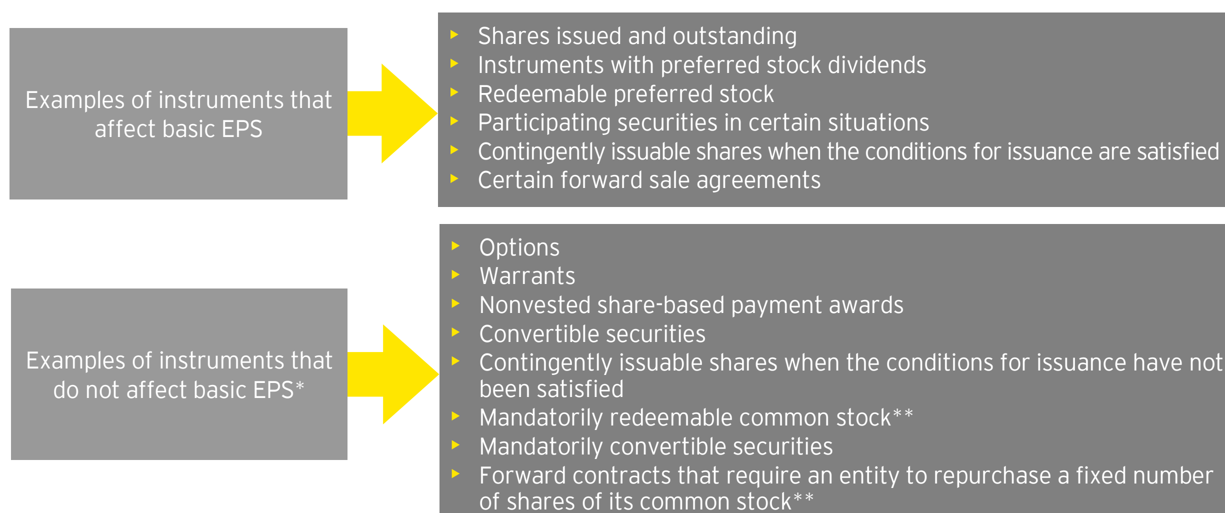
Basic EPS shall be computed by dividing **income available to common stockholders** (the numerator) by the **weighted-average number of common shares outstanding** (the denominator) during the period. Shares issued during the period and shares reacquired during the period shall be weighted for the portion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

Basic EPS is calculated by dividing income available to common stockholders (i.e., net income or loss attributable to the parent entity adjusted for preferred stock dividends declared or accumulated, income attributable to noncontrolling interests, and other relevant adjustments) by the weighted average number of common shares outstanding. Options, warrants and their equivalents (e.g., certain forward contracts), nonvested share-based payment awards, and convertible securities are excluded from the basic EPS calculation. Contingently issuable shares (i.e., shares issuable for little or no cash consideration upon the satisfaction of certain conditions) are included in basic EPS only if all the necessary conditions for the issuance of such shares have been satisfied by the end of the period (e.g., the issuance of shares is no longer contingent on any conditions except for the passage of time). See further discussion on contingently issuable shares in section 3.3.2.

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 should exclude the common shares that are to be redeemed or repurchased when calculating basic (and diluted) EPS. See further discussion in section 4.10.

For an illustration of the guidance on computing quarterly and year-to-date basic EPS, refer to Example 1 from ASC 260 in Appendix E.

The graphic below lists examples of instruments that affect and do not affect basic EPS:




* If the securities are not considered participating securities or they meet the definition of contingently issuable shares and the conditions for issuance are not satisfied.

** Common shares that are to be redeemed or repurchased are deducted from common shares outstanding.

## 3.2 Income available to common stockholders and related adjustments (updated August 2023)

**Excerpt from Accounting Standards Codification**

**Earnings Per Share — Overall**

***Other Presentation Matters***

***Income Available to Common Stockholders and Preferred Dividends***

*260-10-45-11*

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.

*260-10-45-11A*

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.

*260-10-45-12*

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.

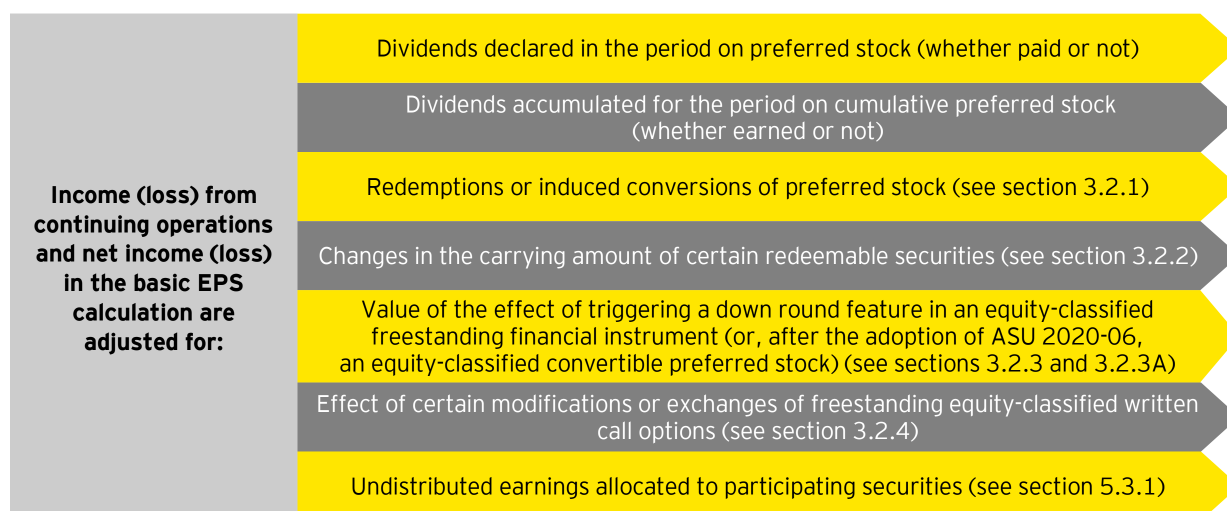
ASC 260-10-45-11 states the numerator to the basic EPS calculation, income available to common stockholders, is computed by deducting (1) dividends declared on preferred stock (whether or not paid) and (2) dividends accumulated on cumulative preferred stock (whether or not earned) from income (loss) from continuing operations and net income (loss). This adjustment for preferred stock dividends is required regardless of the form of the payment (e.g., cash, common shares). However, only dividends related to the current reporting period should be deducted.[1] For example, an entity would only deduct cumulative preferred stock dividends that accumulated in the current reporting period (i.e., not all unpaid cumulative dividends to date). If there is a loss from continuing operations or a net loss, the amount of the loss should be increased by those preferred dividends.

In addition, ASC 260-10-45-11 and the AICPA's non-authoritative Technical Question and Answers (TQA) section 4210.04, *Accrual of Preferred Dividends*, states that if preferred dividends are cumulative only if earned, they should be deducted to arrive at income available to common shareholders only to the extent that they are earned. That TQA also states that in all cases, the effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS should be disclosed for every period for which an income statement is presented. Lastly, the TQA notes that if preferred dividends are not cumulative, only the dividends declared should be deducted.

Certain preferred stock may be issued with an increasing dividend rate (e.g., the preferred stock pays little or no dividends in the early years, but the dividend then increases and usually levels off to a fixed perpetual dividend amount). In such circumstances, it may not be appropriate to use only the stated dividend rate to calculate income available to common stockholders. For further discussion of increasing rate preferred stock discussed in SEC Staff Accounting Bulletin (SAB) Topic 5.Q (codified in ASC 505-10-S99-7), refer to sections 3.4.5.9 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***.

As discussed in ASC 260-10-45-11A, income available to common stockholders should also exclude income (loss) attributable to noncontrolling interests. Other adjustments to income available to common stockholders may be required.

The graphic below summarizes the potential adjustments to income (loss) from continuing operations and net income (loss) to compute income available for common stockholders in the basic EPS calculation:




[1] This is consistent with the guidance in ASC 260-10-45-60B (see section 5.3).

The following illustration shows the effect of dividends on the computation of income available to common stockholders in the computation of basic EPS:

**Illustration 3-1: Calculation of income available to common stockholders**

Net income (loss) for Companies A, B and C follow:

| Company | Net income (loss) |
|---|---|
| A | $ 4,500,000 |
| B | 250,000 |
| C | (1,250,000) |

Companies A, B and C each have 6,000,000 shares of non-redeemable preferred stock outstanding. The dividend rate on the preferred stock is $0.20 per share. For Company A, the preferred stock dividend is noncumulative. For Company B, the dividend is cumulative and there are no dividends in arrears. For Company C, dividends are only cumulative to the extent net income equals or exceeds the dividend requirement (i.e., $1,200,000) in the current year. Company A declared a preferred dividend of $0.20 per share. Companies B and C did not declare dividends on their preferred stock.

The calculation of income available to common stockholders for Company A, B and C is shown below:

| Company | Net income (loss) | Less preferred stock dividends | Income (loss) available to common stockholders |
|---|---|---|---|
| A | $ 4,500,000 | $ 1,200,000 | $ 3,300,000 |
| B | 250,000 | 1,200,000 | (950,000) |
| C | (1,250,000) | 0 | (1,250,000) |

Because Company C incurred a net loss, the dividend is not cumulative under the preferred stock's terms and, accordingly, is not deducted from net loss for EPS purposes. If Company A or B had income (loss) from discontinued operations, the preferred stock dividends also would be deducted from income (loss) from continuing operations to compute EPS from continuing operations, even if doing so resulted in a loss from continuing operations.

### 3.2.1 Effect on the calculation of EPS for a period that includes the redemption or induced conversion of preferred stock

Entities sometimes redeem preferred stock at a premium or discount. A premium paid on redemption represents a return similar to a dividend to the preferred stockholder. Accordingly, the SEC staff requires that the difference between the amount paid upon redemption and the carrying value of the preferred stock be deducted from (if a premium) or added to (if a discount) net income to arrive at income available to common stockholders in the EPS calculation. Issuance costs of the preferred stock reduce the carrying amount of the preferred stock when calculating the premium or discount upon redemption.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*SEC Materials*

*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*

*260-10-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.

**The Effect on Diluted Earnings per Share of a Redemption or Induced Conversion of Only a Portion of a Class of Preferred Stock**

When a registrant effects a redemption or induced conversion of only a portion of the outstanding securities of a class of preferred stock, the SEC staff believes that, for the purpose of determining whether the "if-converted" method is dilutive for the period, the shares redeemed or converted should be considered separately from the other shares of the same class that are not redeemed or converted. The SEC staff does not believe that it is appropriate to aggregate securities with different effective dividend yields when determining whether the "if-converted" method is dilutive, which would be the result if a single, aggregate computation was made for the entire series of preferred stock.

> For example, assume a registrant has 100 shares of convertible preferred stock outstanding at the beginning of the period. The convertible preferred stock was issued at fair value, which was equal to its par value of $10 per share, and has a stated dividend of 5 percent, and each share of preferred stock is convertible into 1 share of common stock. During the period, 20 preferred shares were redeemed by the registrant for $12 per share.
>
> In this example, the SEC staff believes that the registrant should determine whether conversion is dilutive (1) for 80 of the preferred shares by applying the "if-converted" method from the beginning of the period to the end of the period using the stated dividend of 5 percent and (2) for 20 of the preferred shares by applying the "if-converted" method from the beginning of the period to the date of redemption using both the stated dividend of 5 percent and the $2 per share redemption premium.
>
> Accordingly, assuming that the dividend for the period for the preferred stock was $0.125 per share, a determination of whether the 20 redeemed shares are dilutive should be made by comparing the $2.125 per-share effect of assuming those shares are not converted to the effect of assuming those 20 shares were converted into 20 shares of common stock, weighted for the period for which they were outstanding. The determination of the "if-converted" effect of the 80 shares not redeemed should be made separately, by comparing the EPS effect of the $0.125 per-share dividend to the effect of assuming conversion into 80 shares of common stock.

In the event of an induced conversion (as defined in ASC 470-20), the fair value of securities and other consideration transferred to the holders of the convertible preferred stock in excess of the fair value of the securities issuable pursuant to the stated terms of the convertible preferred stock is treated like a dividend (in other words, the excess is deducted from net income to arrive at income available to common stockholders).

As noted in the Scope section in ASC 260-10-S99-2 above, this SEC staff guidance also applies to modifications and exchanges of preferred stock instruments that are accounted for as extinguishments (i.e., which results in a new basis of accounting for the modified or exchanged instrument). While US GAAP does not have explicit guidance on how to determine whether amendments to equity-classified preferred stock instruments constitute an extinguishment, an SEC staff speech[2] provides the staff's view on this evaluation for equity-classified preferred stock. For further discussion, refer to sections 3.6.2.1 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***.

### 3.2.2 Effect of redeemable securities on income available to common stockholders

SEC staff guidance (originally issued as Emerging Issues Task Force (EITF) D-98 and codified in ASC 480-10-S99) requires equity securities to be classified outside permanent equity when their redemption is outside of the issuer's control. For a comprehensive discussion of the SEC staff's guidance on redeemable equity securities, refer to Appendix E of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, or Appendix C of our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***.

Changes in the carrying value of these securities generally affect income available to common shareholders (i.e., the EPS numerator). This section addresses the EPS numerator effects, which can differ depending on whether the redeemable security is preferred or common stock.

As further discussed in Question 1 of Appendix E of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, or Appendix C of our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, although not specifically addressed by the SEC staff's redeemable equity guidance, we generally believe that issuers should follow its provisions (e.g., recognition, measurement, EPS implications) in accounting for equity shares that, although not

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[2] Speech by T. Kirk Crews, 8 December 2014.

redeemable, enable the holder to acquire the issuer's redeemable instruments whose redemption is outside the issuer's control (e.g., convertible preferred stock that is not redeemable but enables the holder to convert into common shares that are puttable to the issuer).

Redeemable shares of a parent entity — preferred stock

**Excerpt from Accounting Standards Codification**

Distinguishing Liabilities from Equity — Overall

*SEC Materials*

*SAB Topic 3.C, Redeemable Preferred Stock*

*480-10-S99-2*

The following is the text of SAB Topic 3.C, Redeemable Preferred Stock.

Facts: Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders' equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission's rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends.

*Question 1: How should the carrying amount of redeemable preferred stock be determined?*

Interpretive Response: The initial carrying amount of redeemable preferred stock should be its fair value at date of issue. Where fair value at date of issue is less than the mandatory redemption amount, the carrying amount shall be increased by periodic accretions, using the interest method, so that the carrying amount will equal the mandatory redemption amount at the mandatory redemption date. The carrying amount shall be further periodically increased by amounts representing dividends not currently declared or paid, but which will be payable under the mandatory redemption features, or for which ultimate payment is not solely within the control of the registrant (e. g., dividends that will be payable out of future earnings). Each type of increase in carrying amount shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital.

The accounting described in the preceding paragraph would apply irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date, or whether it may be converted into another class of securities by the holder. Companies also should consider the guidance in FASB ASC paragraph 480-10-S99-3A (Distinguishing Liabilities from Equity Topic).

*Question 2: How should periodic increases in the carrying amount of redeemable preferred stock be treated in calculations of earnings per share and ratios of earnings to combined fixed charges and preferred stock dividends?*

Interpretive Response: Each type of increase in carrying amount described in the Interpretive Response to Question 1 should be treated in the same manner as dividends on nonredeemable preferred stock.

*SEC Staff Announcement: Classification and Measurement of Redeemable Securities*

*480-10-S99-3A [Selected excerpts]*

14. If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure). The redemption amount at each balance sheet

date should also include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings).[FN13]

FN13 See also Section 260-10-45.

15. If an equity instrument subject to ASR 268 is not currently redeemable (for example, a contingency has not been met), subsequent adjustment of the amount presented in temporary equity is unnecessary if it is not probable that the instrument will become redeemable. If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to either of the following measurement methods provided the method is applied consistently:

    a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates.

    b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

16. The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15:

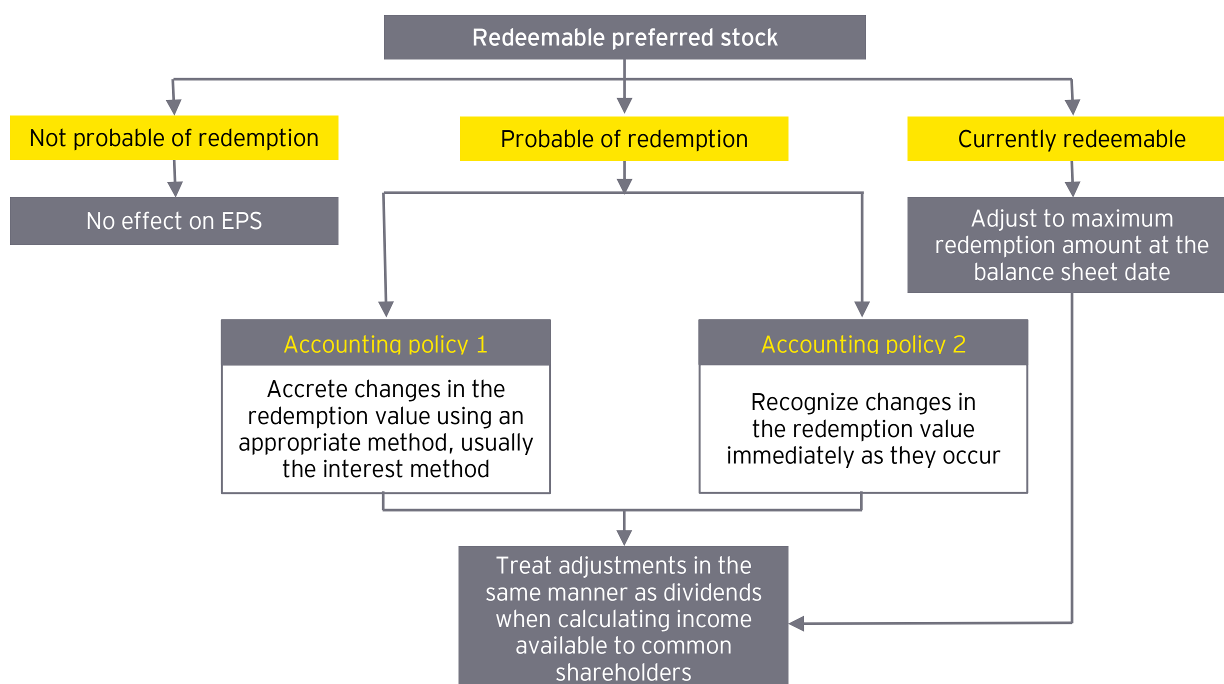
    c. For noncontrolling interests, the adjustment to the carrying amount presented in temporary equity is determined after the attribution of net income or loss of the subsidiary pursuant to Subtopic 810-10.

    e. For a redeemable equity instrument other than those discussed in (a), (b), and (d) of this paragraph, regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and 16 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.

20. *Preferred stock instruments issued by a parent (or single reporting entity)*. Regardless of the accounting method selected in paragraph 15 and the redemption terms (that is, fixed price or fair value), the resulting increases or decreases in the carrying amount of a redeemable instrument other than common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. Increases or decreases in the carrying amount should reduce or increase income available to common stockholders in the calculation of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. Additionally, Paragraph 260-10-S99-2, provides guidance on the accounting at the date of a redemption or induced conversion of a preferred stock instrument.

As stated in paragraph 20 of ASC 480-10-S99-3A, the increases or decreases in the carrying amount of a redeemable preferred stock instrument should be treated in the same manner as dividends on nonredeemable stock. Therefore, increases or decreases in the carrying amount of preferred instruments subject to the SEC staff guidance above reduce or increase the EPS numerator. However, decreases in the instrument's carrying amount should be reflected in the computation of EPS only to the extent they represent recoveries of amounts previously reflected in the computation of EPS.

The flowchart below illustrates how changes in the carrying amount of redeemable preferred stock affect an entity's EPS calculation as discussed in paragraphs 14 and 15 of ASC 480-10-S99-3A:




Redeemable shares of a parent entity — common stock

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***SEC Staff Announcement: Classification and Measurement of Redeemable Securities***

***480-10-S99-3A [Selected excerpts]***

21. *Common stock instruments issued by a parent (or single reporting entity).* Regardless of the accounting method selected in paragraph 15, the resulting increases or decreases in the carrying amount of redeemable common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. However, increases or decreases in the carrying amount of a redeemable common stock should not affect income available to common stockholders. Rather, the SEC staff believes that to the extent that a common shareholder has a contractual right to receive at share redemption (in other than a liquidation event that meets the exception in paragraph 3(f)) an amount that is other than the fair value of the issuer's common shares, then that common shareholder has, in substance, received a distribution different from other common shareholders. Under Paragraph 260-10-45-59A, entities with capital structures that include a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, should apply the two-class method of calculating earnings per share. Therefore, when a class of common stock is

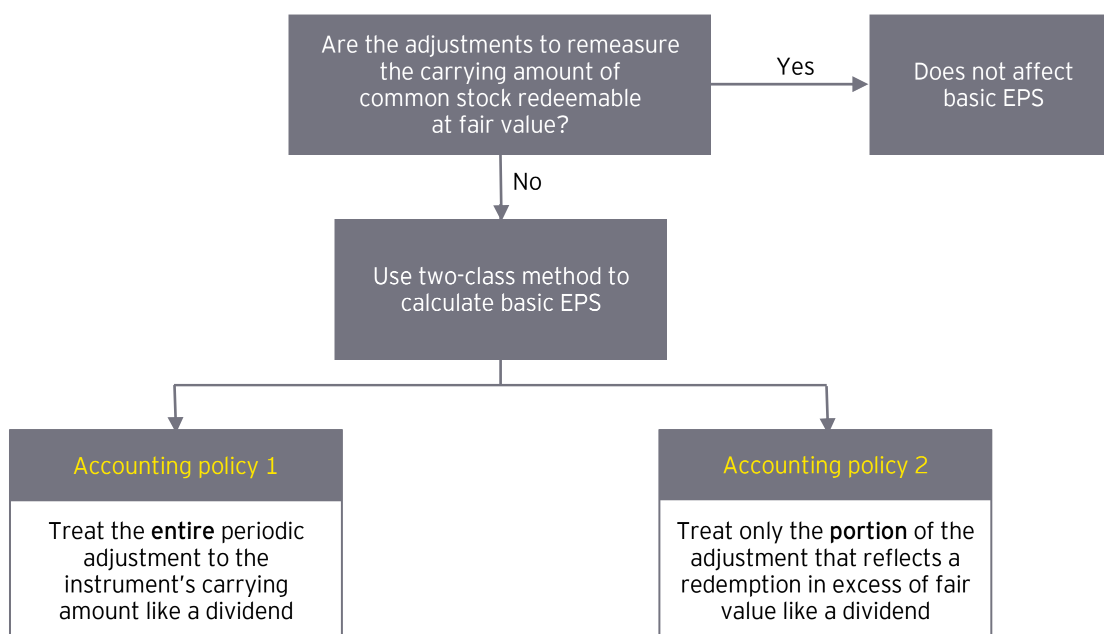
> redeemable at other than fair value, increases or decreases in the carrying amount of the redeemable instrument should be reflected in earnings per share using the two-class method.[FN17] For common stock redeemable at fair value[FN18], the SEC staff would not expect the use of the two-class method, as a redemption at fair value does not amount to a distribution different from other common shareholders.[FN19]
>
> FN17 The two-class method of computing earnings per share is addressed in Section 260-10-45. The SEC staff believes that there are two acceptable approaches for allocating earnings under the two-class method when a common stock instrument is redeemable at other than fair value. The registrant may elect to: (a) treat the entire periodic adjustment to the instrument's carrying amount (from the application of paragraphs 14–16) as being akin to a dividend or (b) treat only the portion of the periodic adjustment to the instrument's carrying amount (from the application of paragraphs 14–16) that reflects a redemption in excess of fair value as being akin to a dividend. Under either approach, decreases in the instrument's carrying amount should be reflected in the application of the two-class method only to the extent they represent recoveries of amounts previously reflected in the application of the two-class method.
>
> FN18 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 considered to be designed to equal or reasonably approximate fair value.
>
> FN19 Similarly, the two-class method is not required when share-based payment awards granted to employees are redeemable at fair value (provided those awards are in the form of common shares or options on common shares). However, those share-based payment awards may still be subject to the two-class method pursuant to Section 260-10-45.

To the extent that a common shareholder has a contractual right to receive at share redemption an amount that is other than the fair value (e.g., a fixed amount) of the issuer's common shares, then that common shareholder has, in substance, received a distribution different from other common shareholders. If an entity has a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, then the entity should apply the two-class method to calculate EPS (see section 5).

From the SEC staff's perspective, redemption at fair value does not amount to a distribution different from other common shareholders, so the use of the two-class method is not expected to be applied. Accordingly, common stock redeemable at fair value does not affect EPS.

While SEC staff guidance on redeemable securities indicates that the two-class method should be applied to common stock redeemable at other than the fair value on the redemption date, it is not clear how this approach would be applied since the two-class method requires an allocation of earnings as if all earnings were distributed during the period. Because the redemption feature has no effect on how earnings are distributed, nor is the redemption amount directly affected by earnings, we believe it is reasonable (and consistent with the SEC staff's intent) to simply adjust earnings available to the common stockholders for the change in redemption amount of the redeemable common stock. As a result, the increases or decreases (only to the extent that those decreases reflect recoveries of amounts previously reflected in applying the two-class method) in the carrying amount of redeemable common stock are treated in the same manner as dividends on nonredeemable stock.

As noted in footnote 17 to paragraph 21 of ASC 480-10-S99-3A, there are two acceptable ways to compute EPS when common stock is redeemable at other than fair value. The flowchart below illustrates the two acceptable approaches:




These alternative approaches are accounting policy elections. The company's election should be applied consistently and disclosed as an accounting policy in the notes to the financial statements.

#### Redeemable noncontrolling interests

Noncontrolling interests first are accounted for in accordance with ASC 810 (refer to sections 15 and 16.1.8 of our FRD, ***Consolidation***). Then, if the noncontrolling interest is considered redeemable under the guidance in ASC 480-10-S99-3A, the redeemable noncontrolling interest is presented in temporary equity (also called the "mezzanine") and subsequently measured in accordance with the SEC staff guidance. The measurement guidance is not applied in lieu of the accounting for noncontrolling interests under ASC 810 but rather is an incremental accounting requirement that is applied after the measurement pursuant to ASC 810 has been determined.

As noted in paragraph 22 of ASC 480-10-S99-3A below, adjustments to the carrying amount of a noncontrolling interest from the application of the SEC staff guidance do not affect net income or comprehensive income in the consolidated financial statements. However, the adjustments may affect EPS. The effect on EPS, if any, will depend on a) whether the noncontrolling interest is represented by the subsidiary's preferred shares or common shares and b) for common shares, whether the redemption amount is at the then-current fair value or some other value.

### Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*SEC Staff Announcement: Classification and Measurement of Redeemable Securities*

*480-10-S99-3A [Selected excerpts]*

22. *Noncontrolling interests*. Paragraph 810-10-45-23 indicates that changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. Consistent with Paragraph 810-10-45-23, an adjustment to the carrying amount of a

noncontrolling interest from the application of paragraphs 14–16 does not impact net income or comprehensive income in the consolidated financial statements. Rather, such adjustments are treated akin to the repurchase of a noncontrolling interest (although they may be recorded to retained earnings instead of additional paid-in capital). The SEC staff believes the guidance in paragraphs 20 and 21 should be applied to noncontrolling interests as follows:

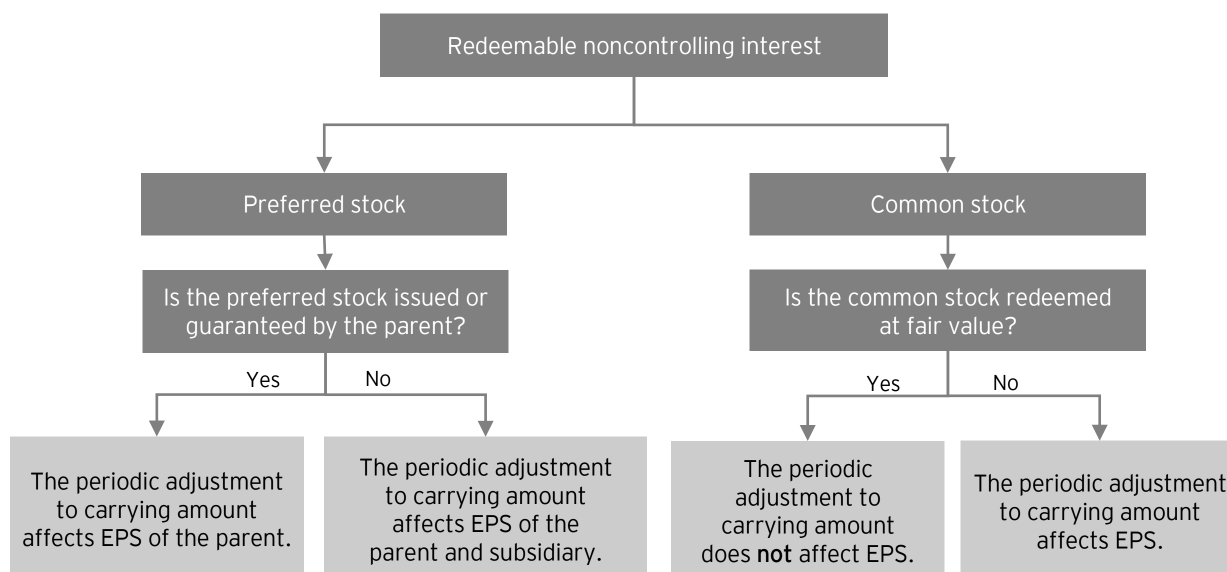
a. *Noncontrolling interest in the form of preferred stock instrument*. The impact on income available to common stockholders of the parent arising from adjustments to the carrying amount of a redeemable noncontrolling interest other than common stock depends upon whether the redemption feature in the equity instrument was issued, or is guaranteed, by the parent. If the redemption feature was issued, or is guaranteed, by the parent, the entire adjustment under paragraph 20 reduces or increases income available to common stockholders of the parent. Otherwise, the adjustment is attributed to the parent and the noncontrolling interest in accordance with Paragraphs 260-10-55-64 through 55-67.

b. *Noncontrolling interest in the form of common stock instrument*. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common stock instrument to reflect a fair value redemption feature do not impact earnings per share. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common stock instrument to reflect a non-fair value redemption feature do impact earnings per share; however, the manner in which those adjustments reduce or increase income available to common stockholders of the parent may differ.[FN20] If the terms of the redemption feature are fully considered in the attribution of net income under Paragraph 810-10-45-21, application of the two-class method is unnecessary. If the terms of the redemption feature are not fully considered in the attribution of net income under Paragraph 810-10-45-20, application of the two-class method at the subsidiary level is necessary in order to determine net income available to common stockholders of the parent.

FN20 Subtopic 810-10 does not provide detailed guidance on the attribution of net income to the parent and the noncontrolling interest. The SEC staff understands that when a noncontrolling interest is redeemable at other than fair value some registrants consider the terms of the redemption feature in the calculation of net income attributable to the parent (as reported on the face of the income statement), while others only consider the impact of the redemption feature in the calculation of income available to common stockholders of the parent (which is the control number for earnings per share purposes).

23. *Convertible debt instruments that contain a separately classified equity component*. For convertible debt instruments subject to ASR 268 (see paragraph 3(e)), there should be no incremental earnings per share accounting from the application of this SEC staff announcement. Subtopic 260-10 addresses the earnings per share accounting.

The flowchart below illustrates the effect of periodic adjustments to the carrying amount of redeemable noncontrolling interest on EPS:




***Redeemable noncontrolling interests in the form of a preferred stock instrument***

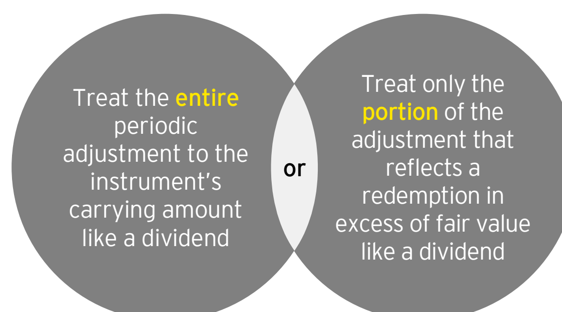
The effect of adjustments to the carrying amount of preferred instruments on income available to common stockholders of the parent depends on whether the redemption feature of the redeemable preferred shares was issued or is guaranteed by the parent. If the redemption feature was issued or guaranteed by the parent, the adjustment to the carrying amount should reduce or increase income available to common stockholders of the parent. If the redemption feature is not issued or guaranteed by the parent, the adjustment should be attributed to the parent and the noncontrolling interest in accordance with the computational guidance for EPS of a subsidiary in Example 7 of ASC 260 (see section 6.1).

***Redeemable noncontrolling interests in the form of a common stock instrument***

Adjustments to the carrying amount of common stock instruments for potential fair value redemptions do not affect EPS. However, adjustments for noncontrolling common stock redeemable at other than fair value (e.g., a fixed amount) do affect EPS. When adjustments of these redeemable equity securities affect EPS, the SEC staff notes that some registrants adjust net income attributable to the parent (as reported on the face of the income statement) for changes in the carrying amount of the redeemable equity securities. However, other registrants do not adjust net income attributable to the parent and only consider the effect of the redemption feature in the calculation of income available to common stockholders of the parent (which may be disclosed on the face of the income statement under the SEC guidance in SAB Topic 6.B discussed in section 7.2.3). These two alternatives affect presentation and disclosure only, but do not affect the amount of reported EPS. These alternative approaches are accounting policy elections and should be applied consistently.

See Illustration 3-2 below for an example of the presentation and disclosure alternatives.

Consistent with the guidance for common stock instruments issued by the parent and based on discussions with the SEC staff, we believe that the registrant may elect to either:




Under either approach, decreases in the instrument's carrying amount should be reflected in the computation of EPS only to the extent they represent recoveries of amounts previously reflected in the computation of EPS.

**Illustration 3-2: EPS presentation alternatives for redeemable equity securities**

Assume on 1 January 20X9, Company P (a public entity) purchases from Company Y 80% of Subsidiary A's common stock, leaving Company Y with a 20% noncontrolling interest at the beginning of Year 20X9. Also assume the 20% noncontrolling interest held by Company Y is redeemable at Company Y's option any time at or after the end of the second year at a formula price based on EBITDA (i.e., a non-fair value redemption feature) and would be redeemed in cash. The noncontrolling interest balance in Subsidiary A on the consolidated financial statements of Company P upon the consummation of the acquisition is $500.

Ignoring quarterly reporting (which would be subject to similar considerations), Subsidiary A's earnings for Year 20X9 are $1,000. Company P first accounts for the noncontrolling interest pursuant to ASC 810 and determines that the carrying value of the noncontrolling interest at the end of Year 20X9 is $700 ((20% x $1,000) + $500). Since Company P is a public entity, it then must consider the application of ASC 480-10-S99-3A.

Since the 20% interest held by Company Y is considered a redeemable noncontrolling interest, it is classified in temporary equity between the liabilities and equity sections of the balance sheet pursuant to ASC 480-10-S99-3A. For measurement purposes, Company P evaluates the two permissible accounting methods pursuant to ASC 480-10-S99-3A and elects to recognize changes in the redemption value immediately as they occur and adjusts the carrying value of noncontrolling interests to equal the redemption value, if higher than the ASC 810 carrying value. Based on the formula price at the end of Year 20X9, the redemption value at the end of Year 20X9 is $850. Accordingly, Company P adjusts the carrying value of its redeemable noncontrolling interest to its redemption value of $850 with a $150 credit ($850 redemption value – $700 carrying value prior to the adjustment) to the noncontrolling interest and a corresponding adjustment to retained earnings (or, if there were no retained earnings, to additional paid-in capital). That $150 debit to retained earnings would reduce the numerator in the EPS calculation. The tax effects of the accretion of the redeemable noncontrolling interest, if any, are not illustrated.

This reduction could be reflected either as an adjustment on the income statement to derive net income attributable to the parent (i.e., a reduction to net income attributable to the parent and an addition to net income attributable to the noncontrolling interest) (refer to Alternative 1) or through the calculation in arriving at income available to common shareholders when deriving EPS (refer to Alternative 2).

The manner in which the reduction is treated is an accounting policy election that should be applied consistently and disclosed in the notes to the financial statements.

The following is an excerpt from Company P's income statement for the year ended 31 December 20X9:

| | Alternative 1 | | Alternative 2 | |
|---|---|---|---|---|
| Net income (loss) | $ 8,160 | | $ 8,160 | |
| Less: Net income attributable to redeemable noncontrolling interest | (350) | (a) | (200) | (b) |
| Net income (loss) attributable to Company P | $ 7,810 | | $ 7,960 | |
| **Earnings (loss) per share — basic:** | | | | |
| Net income (loss) attributable to Company P common stockholders | $ 0.93 | | $ 0.93 | |
| **Earnings (loss) per share — diluted:** | | | | |
| Net income (loss) attributable to Company P common stockholders | $ 0.76 | | $ 0.76 | |
| Weighted average shares outstanding: | | | | |
| Basic | 8,426 | | 8,426 | |
| Diluted | 10,264 | | 10,264 | |

(a) Composed of income attributable to noncontrolling interest in Subsidiary A (calculated as $1,000 x 20%) and accretion of redeemable noncontrolling interest of $150.

(b) $1,000 x 20%.

The following table is an excerpt from the notes to the financial statements where basic and diluted net income attributable to Company P common stockholders per share has been computed:

| | 31 December 20X9 |
|---|---|
| **Alternative 1** | |
| Net income attributable to Company P common shareholders | $ 7,810 |
| **Or** | |
| **Alternative 2** | |
| Net income attributable to Company P | $ 7,960 |
| Accretion of redeemable noncontrolling interest | (150) |
| Net income attributable to Company P common shareholders after accretion of redeemable noncontrolling interest | $ 7,810 |
| **Basic:** | |
| Weighted average shares outstanding and used in the computation of basic net income per share | 8,426 |
| Net income attributable to Company P common shareholders per share — basic | $ 0.93 |
| **Diluted:** | |
| Shares used in the computation of basic net income per share | 8,426 |
| Dilutive effect of stock options | 1,838 |
| Shares used in the computation of diluted net income per share | 10,264 |
| Net income attributable to Company P common stockholders per share — diluted | $ 0.76 |

## 3.2.3 Effect of instruments with down round features on income available to common stockholders (before adoption of ASU 2020-06)

This section addresses the effect of instruments with down round features on income available to common stockholders before the adoption of ASU 2020-06. For discussion of the effect after the adoption of ASU 2020-06, see section 3.2.3A.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Recognition*

*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.

*Initial Measurement*

*260-10-30-1*

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.

*260-10-30-2*

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.

*Subsequent Measurement*

*260-10-35-1*

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.

*Other Presentation Matters*

*Basic EPS*

*Freestanding Equity-Classified Financial Instrument with a Down Round Feature*

*260-10-45-12B*

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).

Equity – Overall

*Disclosure*

*General*

*505-10-50-3A*

For a **financial instrument** with a **down round feature** that has been triggered during the reporting period and for which an entity has recognized the effect in accordance with paragraph 260-10-25-1, an entity shall disclose the following:

a. The fact that the feature has been triggered

b. The value of the effect of the down round feature that has been triggered.

A down round feature is a provision in a financial instrument that reduces the exercise price if the entity sells stock for a lower price or issues an equity-linked instrument with a lower exercise price in the future. Down round features are designed to protect the holder of those instruments from declines in the issuer's share price.

Down round features typically adjust the exercise price of the existing instrument to the new issuance or exercise price. They also can reduce the exercise price based on a formula or set a floor below which the exercise price cannot fall.

The value of the effect of a down round feature in an equity-classified, freestanding financial instrument (e.g., a freestanding warrant) is recognized when the down round feature is triggered (i.e., when the exercise price is adjusted downward). The value of the effect is treated as a dividend and a reduction to income available to common stockholders in the basic EPS calculation. However, when applying the treasury stock method for diluted EPS, this amount is added back to income available to common stockholders. Refer to Example 16 from ASC 260 below.

In addition, when a down round feature is triggered and the entity has recognized its effect pursuant to ASC 260-10-25-1, the entity is required to disclose that fact and the value of the effect of the down round feature.

See section B.3.4.1 of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, for further discussion regarding the recognition and measurement of the effects of down round features in an equity-classified, freestanding financial instrument.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 16: Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature*

*260-10-55-95*

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.

***260-10-55-96***

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.

***260-10-55-97***

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.

## 3.2.3A Effect of instruments with down round features on income available to common stockholders (after adoption of ASU 2020-06)

This section addresses the effect of instruments with down round features on income available to common stockholders after the adoption of ASU 2020-06. For discussion about this effect before the adoption of ASU 2020-06, see section 3.2.3.

**FASB amendment**

With ASU 2020-06, the FASB expanded the scope of the recognition and measurement guidance in ASC 260 to include equity-classified convertible preferred stock that has a down round feature. Before this ASU, the guidance only applied to equity-classified freestanding financial instruments. It was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

### Pending Content:

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*Financial Instruments That Include a Down Round Feature*

*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.

*Initial Measurement*

*260-10-30-1*

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.

*260-10-30-2*

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.

*Subsequent Measurement*

*260-10-35-1*

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.

*Other Presentation Matters*

*Basic EPS*

*Freestanding Equity-Classified Financial Instrument with a Down Round Feature*

*260-10-45-12B*

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).

Equity — Overall

*Disclosure*

*General*

*505-10-50-3A*

For a **financial instrument** with a **down round feature** that has been triggered during the reporting period and for which an entity has recognized the effect in accordance with paragraph 260-10-25-1, an entity shall disclose the following:

a. The fact that the feature has been triggered

b. The value of the effect of the down round feature that has been triggered.

A down round feature is a provision in a financial instrument that reduces the exercise price if the entity sells stock for a lower price or issues an equity-linked instrument with a lower exercise price in the future. Down round features are designed to protect the holder of those instruments from declines in the issuer's share price.

Down round features typically adjust the exercise price of the existing instrument to the new issuance or exercise price. They also can reduce the exercise price based on a formula or set a floor below which the exercise price cannot fall.

The value of the effect of a down round feature in an equity-classified, freestanding financial instrument (e.g., a freestanding warrant) or an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) is recognized when the down round feature is triggered (i.e., when the exercise price is adjusted downward). The value of the effect is treated as a dividend and a reduction to income available to common stockholders in the basic EPS calculation. However, when applying the treasury stock method for diluted EPS, this amount is added back to income available to common stockholders. Refer to Example 16 from ASC 260 below.

In addition, when a down round feature is triggered and the entity has recognized its effect pursuant to 260-10-25-1, the entity is required to disclose that fact and the value of the effect of the down round feature.

As discussed in the Background Information and Basis for Conclusions of ASU 2020-06,[3] the FASB amended the scope of the above guidance to include equity-classified convertible preferred stock because these instruments will no longer be evaluated under the legacy beneficial conversion feature guidance after the adoption of ASU 2020-06. That is, the Board decided that a down round feature included in an equity-classified convertible preferred stock should have the same accounting treatment as a down round feature included in, for example, an equity-classified freestanding warrant or option.

[3] Paragraph BC61 of ASU 2020-06.

However, the FASB decided not to expand the scope of this guidance to convertible debt instruments because ASC 825 already requires that an entity disclose fair value information for convertible debt instruments (i.e., changes in the down round feature, such as a trigger, should be captured within that fair value measure).[4]

See sections B.3.4.1 and C.4.5 of our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for further discussion regarding the recognition and measurement of the effects of down round features.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 16: Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature*

*260-10-55-95*

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.

*260-10-55-96*

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.

*260-10-55-97*

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 |

[4] Paragraph BC62 of ASU 2020-06.

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.

### 3.2.4 Effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders (updated August 2023)

Entities modify or exchange freestanding equity-classified written call options (e.g., warrants) for different reasons. For example, they may modify warrants in connection with the issuance of new debt or equity instruments or in connection with a modification of an existing debt instrument. They also may modify these instruments to compensate the counterparty for services or goods or for other reasons (e.g., to provide value to an instrument holder in lieu of a dividend).

An issuer considers the facts and circumstances of a modification or exchange of an equity-classified freestanding written call option that remains equity classified after the modification or exchange and applies the guidance in ASC 815-40-35-14 through 35-17 to account for the resulting change in fair value of the written call option (measured as the difference between the fair value of the modified or exchanged written call option and the fair value of the original written call option immediately before it is modified or exchanged). ASC 815-40-35-17(d) requires that if the modification or exchange is due to reasons other than to issue equity, or to issue or modify debt, the resulting change is accounted for in accordance with ASC 260-10-45-15 as a dividend that reduces income available to common stockholders in the basic EPS calculation (if the modification or exchange is not in the scope of other guidance, such as ASC 718).

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Basic EPS*

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

*260-10-45-15*

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).

Derivates and Hedging — Contracts in Entity's Own Equity

*Subsequent Measurement*

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

*815-40-35-16*

An entity shall treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option as an exchange of the original instrument for a new instrument. In substance, the entity repurchases the original instrument by issuing a new instrument. For transactions recognized in accordance with paragraph 815-40-35-17(c), the effect of a modification or an exchange shall be measured as the difference between the **fair value** of the modified or

exchanged instrument and the fair value of that instrument immediately before it is modified or exchanged. For all other transactions recognized in accordance with paragraph 815-40-35-17, the effect of a modification or an exchange shall be measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged. In a multiple-element transaction, the total effect of the modification or exchange shall be allocated to the respective elements in the transaction.

*815-40-35-17*

An entity shall recognize the effect of a modification or an exchange (calculated in accordance with paragraph 815-40-35-16) in the same manner as if cash had been paid as consideration, as follows:

a. Equity issuance. An entity shall recognize the effect of a modification or an exchange that is directly attributable to a proposed or actual equity offering as an equity issuance cost. For additional guidance see SAB Topic 5.A, Expenses of Offering (paragraph 340-10-S99-1).

b. Debt origination. An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to an issuance of a debt instrument as a debt discount or debt issuance cost in accordance with the guidance in Topic 835 on interest.

c. Debt modification. An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to a modification or an exchange of an existing debt instrument in accordance with the guidance in Subtopic 470-50 on debt modifications and extinguishments and Subtopic 470-60 on troubled debt restructurings by debtors.

d. Other. An entity shall recognize the effect of a modification or an exchange that is not related to a financing transaction in (a) through (c) and is not within the scope of any other Topics (such as Topic 718) as a dividend. Additionally, for an entity that presents earnings per share (EPS) in accordance with Topic 260, that effect shall be treated as a reduction of income available to common stockholders in **basic earnings per share** in accordance with the guidance in paragraph 260-10-45-15.

*Disclosure*

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

*815-40-50-6*

For a freestanding equity-classified written call option modified or exchanged during any of the periods presented and for which an entity has recognized the effect in accordance with paragraph 815-40-35-17, an entity shall disclose the following:

a. Information about the nature of the modification or exchange transaction (see paragraph 815-40-35-15)

b. The amount of the effect of the modification or exchange (see paragraph 815-40-35-16)

c. The manner in which the effect of the modification or exchange has been recognized (see paragraph 815-40-35-17).

Also see section 4.4.6.1.1 of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, or section 4.4.5.1.1 of our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for further discussion of this ASC 815 guidance.

The guidance above only applies to modifications or exchanges of equity-classified written call options that remain equity classified after the modification or exchange, rather than all equity-classified freestanding forwards and options. This means that it does not apply to modifications of equity-classified forward contracts or purchase options of an entity's own shares, for example.

Modifications or exchanges that are not related to financings or compensation for goods and services (i.e., those discussed in ASC 815-40-35-17(d)) are not common. However, because such a transaction does not represent costs of financing and is not in the scope of other US GAAP (e.g., compensation cost under ASC 718), it should be accounted for as a dividend by the issuer.[5]

Case B of Example 22 of ASC 815-40 illustrates the guidance as follows:

**Excerpt from Accounting Standards Codification**

**Derivates and Hedging — Contracts in Entity's Own Equity**

*Implementation Guidance and Illustrations*

*Example 22: Modification of Equity-Classified Warrants*

*815-40-55-49*

This Example illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have a 10-year term and are exercisable at any time. At issuance, Entity A determines that the warrants are equity classified in accordance with this Subtopic. Prior to the modifications described in Cases A, B, and C, the warrants have not been modified since issuance and remain equity classified.

**Case B: Warrant Modification Recognized as a Dividend**

*815-40-55-51*

Entity A extends the term of the outstanding warrants, which results in an increase in the fair value of the outstanding warrants. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. The warrant holder is a nonemployee investor that has no other commercial relationship with Entity A. The modification is not executed in contemplation of an imminent equity offering or a financing transaction. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification do not indicate that there are other transactions entered into contemporaneously or in contemplation of the warrant modification or other rights and privileges obtained or obligations incurred to achieve an overall economic effect. Entity A concludes that the warrant modification is not related to a financing or compensation for goods and services and is not within the scope of another Topic. At the date on which Entity A and the warrant holder execute the modification, Entity A recognizes the incremental fair value of the outstanding warrants as a dividend to the warrant holder in accordance with paragraph 815-40-35-17(d). See paragraphs 260-10-45-15 and 260-10-45-22 through 45-27 for earnings-per-share guidance and paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 for disclosure guidance.

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[5] Paragraph BC18 of ASU 2021-04.

## 3.3 Weighted average shares outstanding

### 3.3.1 Computing a weighted average

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Computing a Weighted-Average*

*260-10-55-2*

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.

See the following illustration for an example of the computation of weighted average shares outstanding (i.e., the denominator of the basic EPS calculation):

**Illustration 3-3: Computation of weighted average shares outstanding**

Assume the number of shares of common stock outstanding on 1 January 20X1 was 4,000,000. On 15 January 20X1, 150,000 shares of common stock were issued for cash. On 1 March 20X1, an additional 300,000 shares of common stock were issued for cash. On 16 March 20X1, 200,000 treasury shares were repurchased in market transactions.

The weighted average share calculation for the *first quarter* ended 31 March 20X1 follows (assume there are 90 days in the period):

| | |
|---|---|
| Shares of common stock outstanding on 1 January 20X1 [4,000,000 x (90 days outstanding / 90 days in the period)] | 4,000,000 |
| Shares of common stock issued on 15 January 20X1 for cash [150,000 x (75/90)] | 125,000 |
| Shares of common stock issued on 1 March 20X1 for cash [300,000 x (30/90)] | 100,000 |
| Shares of common stock repurchased on 16 March 20X1 [200,000 x (15/90)] | (33,333) |
| Weighted average common shares outstanding for the first quarter ended 31 March 20X1 | **4,191,667** |

Assume the same share information as above, and on 30 June 20X1, 500,000 shares of common stock were issued for cash. The weighted average share calculation for the *year* ended 31 December 20X1 follows:

| | |
|---|---|
| Shares of common stock outstanding at the beginning of 20X1 [4,000,000 x (365/365)] | 4,000,000 |
| Shares of common stock issued on 15 January 20X1 for cash [150,000 x (350/365)] | 143,836 |
| Shares of common stock issued on 1 March 20X1 for cash [300,000 x (305/365)] | 250,685 |
| Shares of common stock repurchased on 16 March 20X1 [200,000 x (290/365)] | (158,904) |
| Shares of common stock issued on 30 June 20X1 for cash [500,000 x (184/365)] | 252,055 |
| Weighted average common shares outstanding for the year ended 31 December 20X1 | **4,487,672** |

### 3.3.2 Treatment of contingently issuable shares in weighted average shares outstanding (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Treatment of Contingently Issuable Shares in Weighted-Average Shares Outstanding*

*260-10-45-12C*

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.

*260-10-45-13*

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 are considered outstanding common shares and included in basic EPS as of the date that all necessary conditions have been satisfied (i.e., when issuance of the shares is no longer contingent on any conditions except the passage of time). If the contingency has been satisfied, such shares are to be considered outstanding for basic EPS computations, even if the shares physically have not been issued. Unlike the requirements for diluted EPS (see section 4), a continued service vesting requirement is considered a contingency for purposes of calculating basic EPS. Shares must be completely vested to be included in the denominator for basic EPS. Thus, if 500,000 shares have been issued in a restricted stock plan, and 300,000 of those shares have not yet vested, only 200,000 shares would be included as outstanding in calculating basic EPS. However, if all 500,000 shares were vested but had not physically been issued, then all 500,000 shares would be included as outstanding in calculating basic EPS. This situation may occur when restricted stock units (or similar instruments) are granted and permit or require deferral of the settlement in shares to a date subsequent to the vesting of the restricted stock units.

As another example, nonvested 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 earlier of (1) the stated vesting date or (2) the date the employee becomes eligible for retirement. This is because there is no service period associated with these awards after this point in time. That is, the employee could retire at any point, and upon retirement the awards immediately vest.

A prepaid forward sale contract is another example of a security that meets the definition of a contingently issuable share. In a prepaid forward sale contract, a counterparty prepays an entity a fixed amount up front in exchange for delivery of the entity's shares at a future date. The number of shares to be delivered can be either fixed or variable. In a prepaid forward sale contract to deliver a fixed number of shares, because the delivery of the shares is certain and the contract price is prepaid, the fixed number of shares are included in the basic EPS denominator as contingently issuable shares for which all conditions for their issuance (other than the passage of time) have been met. There is no further effect on diluted EPS.

In a prepaid forward sale contract to deliver a variable number of shares, there is often a minimum number of shares that must be delivered and, therefore, those shares should be included in the basic EPS denominator, similar to a fixed prepaid forward sale contract. Any additional shares over the minimum that may need to be issued are excluded from the basic EPS denominator and should be considered for inclusion in the diluted EPS calculation using the contingently issuable share guidance as discussed in section 4.8.

If shares are returnable or placed in escrow until the shares are vested or some other contingent criteria (other than the passage of time) are met, the shares should be excluded from the denominator in computing basic EPS even if they have been issued. Previously reported basic EPS amounts are not restated when the contingency is satisfied. For a detailed example of the effect of contingently issuable shares on the calculation of both basic and diluted EPS, see section 4.8.5.

**Question 3-1** **How should an entity evaluate a clawback provision when calculating basic EPS?**

Some share-based payments contain provisions that require the grantee to return equity instruments or any gains from the sale of equity instruments on the occurrence of certain future events. These provisions, commonly characterized as "clawback provisions," are usually triggered by noncompete, non-solicitation or fraudulent behavior provisions. Clawback provisions may also be triggered by other events, such as a restatement of financial statements, which might arise after a share-based payment has already been earned. Under ASC 718, the effect of such contingent features is accounted for when the contingent event occurs (i.e., when the clawback feature is triggered). As such, clawback provisions do not impact basic EPS calculations before they are triggered. When a clawback feature is triggered, the impact on the EPS calculation may require significant judgment based on the facts and circumstances.

**Question 3-2** **How should an entity evaluate shares issued upon an early exercise of stock options when calculating basic EPS?**

Option plans may permit grantees to "early exercise" options (e.g., remit cash consideration or a recourse note to the entity for the exercise price) in exchange for shares before the goods are delivered or service is rendered (e.g., before the grantee vests in the award). Usually, early exercise is used to achieve a more favorable tax position. While the grantee is deemed to own the shares resulting from an early exercise of an option for tax purposes, the option was exercised before the grantee actually vested in the award under its original terms. Consequently, the restricted shares received by the grantee contain a repurchase provision (i.e., a grantor call option) contingent on the grantee's forfeiture of the award (e.g., employee's termination). Accordingly, shares issued upon an early exercise of stock options are excluded from the basic EPS calculation until the shares are vested.

### 3.3.3 Business combinations and reorganizations

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Business Combinations and Reorganizations*

*260-10-55-17*

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.

For purposes of computing the weighted average shares outstanding when common shares are issued in connection with the acquisition of a business in a transaction that is accounted for as a business combination pursuant to ASC 805, the shares and other potential common shares would be included in the weighted average shares outstanding from the acquisition date. That is, previously reported EPS should not be adjusted retrospectively to reflect such issuance of shares.

For reorganizations, EPS computations should be based on the facts and circumstances of the transaction. Retrospective adjustments of previously reported EPS amounts generally occur in the circumstances described in section 7.3, which would include a reverse acquisition.

# 4 Diluted EPS

## 4.1 Computation of diluted EPS (updated September 2024)

**FASB amendment**

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The amendments to ASC 260 related to the diluted EPS calculation (shown as pending content throughout section 4):

- Require the use of the average share price to calculate the number of shares included in the denominator under both the treasury stock method and the if-converted method if the number of potential common shares is variable (see sections 4.1, 4.3.1 and 4.6.1A)
- Require the use of the if-converted method to calculate diluted EPS for all convertible instruments (see section 4.6)
- Modify the if-converted method so that interest charges on convertible debt for which the principal is required to be paid in cash would not be added back to the numerator (see section 4.6)
- Require the inclusion of the effect of potential share settlement (if the effect is more dilutive) for instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, regardless of whether the entity or the holder can choose between cash and share settlement, or the entity has a history or policy of cash settlement (see section 4.9A)
- Conform the calculation of the denominator in the year-to-date diluted EPS calculation when an entity must adjust the numerator to remove the earnings effect of contracts that are asset- or liability-classified but are presumed to be share-settled for EPS purposes to be consistent with the year-to-date calculation under the treasury stock method (see section 4.9A)

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Objectives*

*Diluted EPS*

*260-10-10-2*

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.

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Computation of Diluted EPS*

*260-10-45-16*

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

*260-10-45-16*

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.

*Conversion Rate or Exercise Price*

*260-10-45-21*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*Variable Denominator*

*260-10-45-21A*

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.

Diluted EPS is the second EPS measure required to be disclosed by ASC 260. Diluted EPS is a measure of the performance of an entity over the reporting period that begins with the calculation of basic EPS but then gives effect to all potential common shares that were dilutive and outstanding during the period by increasing the denominator. Certain numerator adjustments may also be required, as discussed further in this section. For an illustration of the guidance on computing quarterly and year-to-date diluted EPS, refer to Example 1 from ASC 260 in Appendix E. The denominator includes the number of *additional* common shares that would have been outstanding if the potential common shares that were dilutive had been issued. That is, decreasing the number of shares in the denominator would be antidilutive because it does not align with the guidance in ASC 260-10-45-16 requiring that the denominator in the diluted EPS calculation be increased. Potential common shares are securities (such as options, warrants, share-based payments, convertible debt and convertible preferred stock) that may entitle the holder to obtain common stock during the reporting period or after the end of the reporting period.

In accordance with ASC 260-10-45-21, diluted EPS is computed based on the most advantageous conversion rate or exercise price from the standpoint of the security holder. This would include any exercise or conversion prices available to the investor as of the balance sheet date or at some date in the future as a result of the mere passage of time. However, we generally do not believe that potential changes to the exercise or conversion price that are contingent on a future event need to be considered in the calculation of diluted EPS until that event occurs and the exercise price or conversion price is available (however, see the discussion of disclosures required in such circumstances in section 7.2). Previously reported diluted EPS data is not retroactively adjusted for subsequent conversions or subsequent changes in the market price of the common stock.

The following illustration depicts the guidance discussed above for awards when the exercise and conversion prices vary as a result of the mere passage of time:

**Illustration 4-1 Number of common shares and exercise price vary over time**

On 1 January 20X1, Company A issued a warrant to Company B under which Company B has the right, but not the obligation, to buy Company A's common shares at any time from the issuance date until 31 December 20X2. The warrant contains the following key terms:

- Company B can exercise the warrant for the number of common shares based on the date of exercise as follows:
  - If exercised before 31 December 20X1 — 10,000 common shares
  - If exercised between 1 January 20X2 and 31 December 20X2 — 12,000 common shares
- The exercise price of the warrant for each common share purchased depends on the date of exercise as follows:
  - If exercised before 31 December 20X1 — $10 per share
  - If exercised between 1 January 20X2 and 31 December 20X2 — $8 per share

From the standpoint of Company B, it is most advantageous to exercise the warrant between 1 January 20X2 and 31 December 20X2 because Company B pays a lower exercise price and can purchase more common shares. Therefore, Company A should assume an $8 exercise price per common share on 12,000 potential common shares in calculating diluted EPS.

After the adoption of ASU 2020-06, entities are required under ASC 260-10-45-21A to use an average market price to calculate the diluted EPS denominator (using either the if-converted or treasury stock method) if the number of potential common shares is variable, such as when (1) the exercise prices may change based on an entity's share price or (2) changes in the entity's share price may affect the number of shares that may be used to settle a financial instrument.

As noted in the Basis for Conclusions of ASU 2020-06,[6] the amendment related to the use of the average share price when the number of potential common shares is variable is intended to reduce diversity in practice and is consistent with the existing requirements in ASC 260-10-55-4 through 55-5 (see section 4.3.1) under the treasury stock method. The Board decided that using an average share price provides the most consistent calculations for the if-converted method because an average price would be less volatile than a price determined at a point in time. As noted in ASC 260-10-45-21A, contingently issuable shares in the scope of ASC 260-10-45-48 through 45-57 (see section 4.8) are excluded from this guidance.

### Diluted EPS calculation methods

In computing diluted EPS, the dilutive effect of call options, warrants, share-based payment awards, forward contracts and employee stock purchase plans is calculated using the treasury stock method, which assumes that the proceeds of exercise are used to purchase common shares at the average market price for the period. See sections 4.3 and 4.4 for further discussion of the treasury stock method.

Before the adoption of ASU 2020-06, the dilutive effect of *traditional* convertible debt and preferred stock is calculated using the if-converted method. Under the if-converted method, securities are assumed to be converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares are included in the denominator of the diluted EPS calculation for the period that they were outstanding. Interest (including the effect of accretion of discounts or amortization of premiums, as well as amortization of debt issuance costs), net of any income tax effects and dividends on convertible securities, are added back to the numerator for purposes of the if-converted calculation. In addition, the numerator is adjusted for the after-tax effects of any nondiscretionary adjustments based on income that would have been computed differently had interest or dividends not been recognized, such as expense resulting from profit-sharing plans. Other numerator adjustments may also be required to remove the effect convertible securities may have had during the period to be consistent with the assumption of the if-converted method that the securities were converted as of the beginning of the period. See section 4.6 for further discussion of the if-converted method.

After the adoption of ASU 2020-06, the dilutive effect of *all* convertible instruments is calculated using the if-converted method. Under legacy GAAP, the treasury stock method is used to calculate the dilutive effect on EPS for some of them (e.g., convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash but may settle the conversion premium in cash or shares — also known as Instrument C — see section 4.9.1A). ASU 2020-06 also modifies the if-converted method so that interest charges on convertible debt for which the principal is required to be paid in cash would not be added back to the numerator. See section 4.6 for further discussion of the if-converted method and section 4.9A on instruments that may be settled in cash or shares after the adoption of ASU 2020-06.

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[6] Paragraph BC115 of ASU 2020-06.

Diluted EPS also includes certain shares that are contingently convertible (see section 4.7) or contingently issuable (see section 4.8). For example, contingently issuable shares are included in the denominator for the entire period if such shares would be issuable as of the end of the reporting period assuming the end of the reporting period was the end of the contingency period. That is, if attainment or maintenance of a specified level of income is the condition for issuance and that level is met as of the end of the reporting period, the contingently issuable shares should be included in the diluted calculation (provided they are dilutive). The calculation should not reflect further dilution that could arise if a higher level of earnings was achieved and additional shares would become issuable. For diluted EPS purposes, performance-based stock options and other awards are considered contingently issuable, but awards subject only to service vesting are not.

Before the adoption of ASU 2020-06, for contracts that may be settled in cash or shares, the numerator may need to be adjusted for any other changes in income or loss that would result from the assumed settlement of the instruments in cash or shares. A numerator adjustment also may be required for certain other equity-linked instruments with assumed share settlement. See section 4.9 for further discussion of contracts that may settled in cash or shares before the adoption of ASU 2020-06.

After the adoption of ASU 2020-06, for contracts that may be settled in cash or shares and aren't liability-classified share-based payment awards, entities are required to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement or whether the entity has a history or policy of cash settlement. As a result, maximum potential dilution will be reflected in diluted EPS. Entities may report lower diluted EPS than they would under the legacy guidance, and the effect on EPS may not reflect an entity's expectations before settlement (i.e., if the entity intends to settle the instrument in cash).

The legacy guidance in ASC 260 allowing an entity to overcome the presumption of share settlement in some cases will continue to apply to certain liability-classified share-based payment awards.

Numerator adjustments arise when, for example, the presumption for EPS purposes is stock settlement, but the instrument is classified as an asset or liability for accounting purposes. Similar adjustments may continue to be required after the adoption of ASU 2020-06. See section 4.9A for further discussion of contracts that may be settled in cash or shares after the adoption of ASU 2020-06.

For contracts that require that the reporting entity repurchase its own stock, such as written put options and certain forward purchase contracts, any potential dilutive effect on EPS is computed using the reverse treasury stock method. See section 4.10 for further discussion of the reverse treasury stock method.

Only securities that are dilutive are included in the calculation of diluted EPS. Purchased options should be excluded from the diluted EPS calculation because it would be antidilutive to include them (see section 4.11).

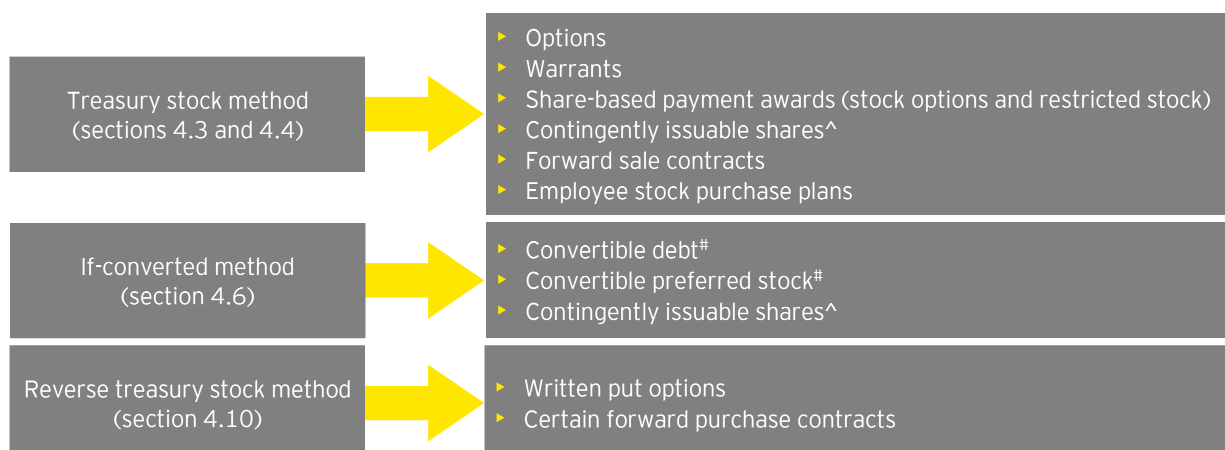
Entities reporting discontinued operations are required to use income from continuing operations (attributable to the parent entity) as the "control number" or benchmark to determine whether potential common shares are dilutive or antidilutive. For example, if an entity has a loss from continuing operations and the issuance of option shares would be antidilutive due to the loss, but the entity has net income as a result of discontinued operations, potential common shares are excluded from the diluted EPS calculation even though the effect on net income would be dilutive. In certain situations, securities may be dilutive even in a period of a loss. See further discussion on antidilution in section 4.2 and Illustration 4-14 in section 4.9 (before the adoption of ASU 2020-06) or Illustration 4-15 in section 4.9A (after the adoption of ASU 2020-06).

As further discussed in section 5, entities that have multiple classes of common stock or have issued participating securities are required to apply the two-class method to compute EPS. We believe the dilutive effect of each participating security or second class of common stock should be calculated using

the more dilutive of either (1) the treasury stock method, reverse treasury stock method or if-converted method, as applicable, or (2) the two-class method. See section 5.3.3 for further discussion of diluted EPS under the two-class method.

Instruments that must be settled in cash do not affect diluted EPS since they do not meet the definition of potential common stock.

The following graphic shows which method is used to calculate the potentially dilutive effect of various instruments for diluted EPS*:




* If an entity is required to apply the two-class method, we believe it should apply the more dilutive of either (1) the treasury stock method, if-converted method, reverse treasury stock method or (2) the two-class method in its diluted EPS calculation. See section 5.3.3.

^ The method for calculating the dilutive effect on EPS will depend on the nature of the potentially dilutive security. See section 4.8.

\# Before the adoption of ASU 2020-06, while the if-converted method is used for most convertible instruments, the dilutive effect on EPS is calculated for certain convertible instruments (e.g., convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash but may settle the conversion premium in cash or shares (see section 4.9.1)) using the treasury stock method. After the adoption of ASU 2020-06, the if-converted method should be used for all convertible instruments (see section 4.9A).

## 4.2 Antidilution (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

*Antidilution*

An increase in earnings per share amounts or a decrease in loss per share amounts.

*Other Presentation Matters*

*No Antidilution*

*260-10-45-17*

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.

In computing diluted EPS, only potential common shares that are dilutive (i.e., those that reduce EPS or increase loss per share) are included. Each issue or series of issues of potential common shares should be considered separately when determining whether potential common shares are dilutive or antidilutive.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*No Antidilution*

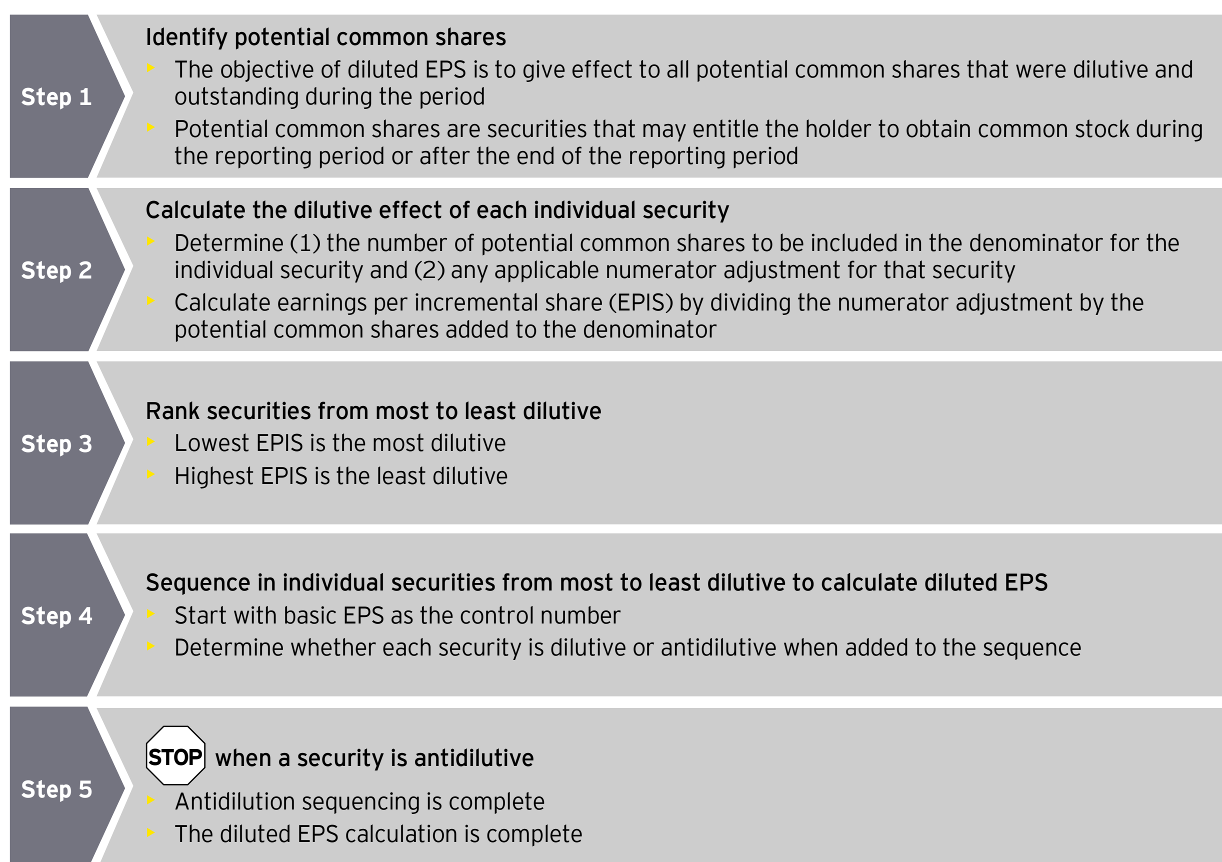
*260-10-45-18*

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. 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.

*Antidilution sequencing*

The sequence in which potential common shares are considered in the computation of diluted EPS (referred to as "antidilution sequencing") may affect the amount of dilution that they produce. In this regard, convertible securities may be dilutive when considered individually but antidilutive when combined with other potential common shares in computing diluted EPS. To reflect the maximum potential dilution, each issue or series of issues of potential common shares should be considered in sequence from the most dilutive to the least dilutive. If including the next group of potential common shares in the sequence results in a higher EPS (or decrease in loss per share) than prior to their inclusion, the potential shares are antidilutive, and they should not be included in the calculation of diluted EPS. That is, dilutive potential common shares with the lowest "earnings per incremental share" should be included in diluted EPS before those with higher earnings per incremental share. Options and warrants generally will be included first because use of the treasury stock method often does not affect the numerator of the EPS computation.

The chart below summarizes a process for antidilution sequencing:




The following example illustrates antidilution sequencing:

**Illustration 4-2: Antidilution sequencing in diluted EPS calculation**

Assume the following facts for Company A:

- Income available to common stockholders was $25,000,000 for the year 20X1
- The number of weighted average common shares outstanding during 20X1 was 4,000,000
- The average market price of Company A's common stock was $150
- Company A had the following potential common shares outstanding during the year:
  1. Options to buy 200,000 shares of common stock at $120 per share
  2. Convertible debentures (5% yield) with a principal amount of $200,000,000 (issued at par). Each $1,000 debenture is convertible into 20 shares of common stock.
  3. Convertible preferred stock (1,000,000 shares) entitled to a cumulative dividend of $9 per share. Each preferred share is convertible into 2 shares of common stock.
- The tax rate is 40% for 20X1

Under ASC 260, diluted EPS is determined first by calculating separately the dilutive effect of the three securities (i.e., determining the earnings per incremental share).

Determination of earnings per incremental share:

| | Increase in available income | | Increase in number of common shares | | Earnings per incremental share |
|---|---|---|---|---|---|
| Options | – | (a) | 40,000 | (b) | – |
| 5% convertible debentures | $ 6,000,000 | (c) | 4,000,000 | (d) | $ 1.50 |
| Convertible preferred stock | $ 9,000,000 | (e) | 2,000,000 | (f) | $ 4.50 |

(a) The numerator is not adjusted under the treasury stock method, except as described in sections 3.2.3 (before the adoption of ASU 2020-06), 3.2.3A (after the adoption of ASU 2020-06), 4.9 (before the adoption of ASU 2020-06), 4.9A (after the adoption of ASU 2020-06) and 4.10.

(b) [($150 average market price − $120 option price) / $150] x 200,000 options outstanding (see discussion in section 4.3 on the treasury stock method).

(c) ($200,000,000 principal amount x 5% interest) less income taxes of 40%.

(d) 200,000 debentures x 20 shares of common stock per debenture.

(e) 1,000,000 preferred shares x $9 dividend per share.

(f) 1,000,000 preferred shares x 2 common shares.

After computing the earnings per incremental share, the potential common shares are included in computing diluted EPS from the most dilutive (lowest earnings per incremental share) to the least dilutive (highest earnings per incremental share).

Computation of diluted EPS:

| | Income available | Common shares | EPS | |
|---|---|---|---|---|
| As reported | $ 25,000,000 | 4,000,000 | $ 6.25 | |
| Options | – | 40,000 | | |
| | 25,000,000 | 4,040,000 | $ 6.19 | Dilutive |
| 5% convertible debentures | 6,000,000 | 4,000,000 | | |
| | 31,000,000 | 8,040,000 | $ 3.86 | Dilutive |
| Convertible preferred stock | 9,000,000 | 2,000,000 | | |
| | $ 40,000,000 | 10,040,000 | $ 3.98 | Antidilutive |

Because diluted EPS increases from $3.86 to $3.98 when the convertible preferred shares are included in the required sequence in the computation, the convertible preferred shares are antidilutive and, therefore, are excluded from the computation of diluted EPS. Accordingly, diluted EPS would be $3.86.

### *Control number*

An entity that reports a discontinued operation should use income from continuing operations, adjusted for preferred dividends and similar adjustments described in section 3.2, if any, as the "control number" in determining whether potential common shares are dilutive. That is, the same number of potential common shares used in computing the diluted per-share amount of income from continuing operations should be used in computing all other reported diluted per-share amounts even if the effect will be antidilutive compared to their respective basic per-share amounts (as shown in Example 14 from ASC 260 and Illustration 4-3 below).

Income from continuing operations should exclude income attributable to noncontrolling interests, if any. In other words, the numerator of the EPS calculation should begin with income from continuing operations attributable to the parent and net income attributable to the parent.

Example 14 from ASC 260 illustrates the guidance in ASC 260-10-45-18, as follows:

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 14: Antidilutive Securities*

*260-10-55-90*

This Example illustrates the guidance in paragraph 260-10-45-18.

*260-10-55-91*

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.

The following example also illustrates the use of income from continuing operations as the "control number" when an entity reports discontinued operations:

**Illustration 4-3: EPS calculation when an entity reports a discontinued operation**

Assume the following facts for Company A:

- Income from continuing operations of $3,000,000
- Loss from discontinued operations of $3,600,000
- Net loss of $600,000
- 1,000,000 common shares outstanding
- 200,000 incremental common shares outstanding under the treasury stock method relating to stock options

Company A's basic earnings (loss) per-share amounts would be calculated as follows:

| | Numerator | Denominator | Basic EPS |
|---|---|---|---|
| Continuing operations | $ 3,000,000 | 1,000,000 | $ 3.00 |
| Discontinued operations | (3,600,000) | 1,000,000 | (3.60) |
| Net loss | $ (600,000) | 1,000,000 | $ (0.60) |

Company A's diluted earnings (loss) per-share amounts would be calculated as follows:

| | Numerator | Denominator | Diluted EPS |
|---|---|---|---|
| Continuing operations | $ 3,000,000 | 1,200,000 | $ 2.50 |
| Discontinued operations | (3,600,000) | 1,200,000 | (3.00) |
| Net loss | $ (600,000) | 1,200,000 | $ (0.50) |

Company A included the 200,000 potential common shares in the denominator of its diluted per-share computation for continuing operations because the result is dilutive (reduces EPS from continuing operations from $3.00 to $2.50).

Because income from continuing operations is the control number, Company A also must include the 200,000 potential common shares in the denominator for the per-share amounts relating to discontinued operations and net loss even though the resulting per-share amounts ($3.00 per share for the loss from discontinued operations and $0.50 per-share for the net loss) are antidilutive with respect to their comparable basic per-share amounts.

However, if Company A had a loss from continuing operations of $1,000,000, income from discontinued operations of $3,600,000 and net income of $2,600,000, the 200,000 potential common shares would not be included in the computation of diluted EPS because the inclusion of the potential common shares would have an antidilutive effect on the control number (i.e., loss from continuing operations).

In that case, diluted EPS would be determined as follows:

| | Numerator | Denominator | Diluted EPS |
|---|---|---|---|
| Continuing operations | $ (1,000,000) | 1,000,000 | $ (1.00) |
| Discontinued operations | 3,600,000 | 1,000,000 | 3.60 |
| Net income | $ 2,600,000 | 1,000,000 | $ 2.60 |

Note that the dilutive effect of the potential common shares on EPS for income from discontinued operations and net income would not be reported because of the loss from continuing operations.

As discussed further in section 7.1, entities that report discontinued operations must present basic and diluted per-share amounts for that line item either on the face of the statement of operations or in the notes to the financial statements in accordance with ASC 260-10-45-3.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Other Presentation Matters*

***No Antidilution***

*260-10-45-19*

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.

*260-10-45-20*

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.

**Question 4-1** **When an entity is in a loss position (e.g., loss from continuing operations), should potential common shares always be excluded from the denominator when calculating diluted EPS?**

The guidance in ASC 260-10-45-19 indicates that potential common shares will always be antidilutive when an entity is in a loss position, such as when the entity has a loss from continuing operations or a loss from continuing operations available to common stockholders (i.e., after any preferred dividends). Further, ASC 260-10-45-20 states that if there is a loss from continuing operations, diluted EPS would be computed in the same manner as basic EPS. However, we believe that there are situations where it may be appropriate to include potential common shares in the calculation of diluted EPS even when an entity is in a loss position. One example is an instrument that can be settled in shares or cash and is asset- or liability-classified in accordance with ASC 480 or ASC 815 but is assumed to be settled in shares for EPS purposes. This type of instrument is carried at fair value and requires a numerator adjustment based on the guidance in ASC 260-10-55-36A (refer to section 4.9 (before the adoption of ASU 2020-06) or section 4.9A (after the adoption of ASU 2020-06)) to remove the effect of any mark-to-market adjustments recognized during the period. The combined effect of the numerator adjustment and inclusion of potential common shares in the denominator may have a dilutive effect on EPS. This view is consistent with the guidance in ASC 260-10-45-18, which requires entities to consider the potentially dilutive effects of each issue or series of issues of potential common shares separately when calculating diluted EPS. Refer also to Illustration 4-14 in section 4.9 (before the adoption of ASU 2020-06) or Illustration 4-15 in section 4.9A (after the adoption of ASU 2020-06).

## 4.3 Options, warrants and their equivalents and the treasury stock method (updated September 2024)

**FASB amendment**

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The ASU added a consequential amendment to ASC 260-10-45-23 to refer to the new guidance on variable denominators in ASC 260-10-45-21A (included in section 4.1). It also amended ASC 260-10-55-7 to remove references to "convertible securities" or "conversion" because entities will apply the if-converted method for all convertible securities to calculate diluted EPS after adoption.

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Options, Warrants, and Their Equivalents and the Treasury Stock Method*

*260-10-45-22*

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.

*260-10-45-23*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-45-23*

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.

ASC 260-10-45-22 states that the dilutive effect of outstanding call options, warrants and their equivalents issued by the reporting entity generally should be reflected in diluted EPS by application of the treasury stock method. For EPS purposes, equivalents of options and warrants include nonvested stock, stock purchase contracts and partially paid stock subscriptions, as well as forward sale contracts (i.e., a contract requiring the issuer to sell its own shares to the buyer at a predetermined price at a future date). For further discussion of the effect on EPS of share-based payment arrangements, see section 4.4.

In accordance with ASC 260-10-45-23, the treasury stock method assumes (1) exercise of options and warrants at the beginning of the period (or at time of issuance, if later) and issuance of common shares in return and (2) that the proceeds from exercise are used to purchase common stock at the average market price (see section 4.3.1) during the period. The incremental shares (i.e., the difference between the number of shares assumed issued and the number of shares assumed purchased) should be included in the denominator of the diluted EPS computation.

Example 15 from ASC 260 illustrates the guidance in ASC 260-10-45-22 through 45-23, as follows:

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 15: Options, Warrants, and Their Equivalents*

*260-10-55-92*

This Example illustrates the guidance in paragraphs 260-10-45-22 through 45-23.

*260-10-55-93*

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.

*260-10-55-94*

The following is a shortcut formula for that computation (note that this formula may not be appropriate for share-based compensation awards [see paragraph 260-10-45-29]):

> Incremental shares = [(market price - exercise price)/market price] x shares assumed issued under option; thus, [($60 - $54)/$60] x10,000 = 1,000 incremental shares.

The following example also illustrates the computation of the incremental shares included in the weighted average shares outstanding under the treasury stock method:

**Illustration 4-4: Dilutive effect of warrants under the treasury stock method**

Company A has 45,000 equity-classified warrants outstanding exercisable at $25 per share. The average market price of the common stock during the reporting period is $30. Exercise of the warrants and issuance of 45,000 shares of common stock at the beginning of the period would be assumed. The proceeds of $1,125,000 (45,000 warrants x $25) that are assumed to be realized from exercise of the warrants would be assumed to be used to acquire 37,500 ($1,125,000 / $30) shares of common stock in the market. Therefore, the 7,500 (45,000 — 37,500) incremental shares assumed to be issued would be added to the denominator in the diluted EPS calculation for the period. The numerator is not adjusted under the treasury stock method, except as described in sections 3.2.3 (before the adoption of ASU 2020-06), 3.2.3A (after the adoption of ASU 2020-06), 4.9 (before the adoption of ASU 2020-06), 4.9A (after the adoption of ASU 2020-06) and 4.10.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Options, Warrants, and Their Equivalents and the Treasury Stock Method*

*260-10-45-25*

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.

*260-10-45-26*

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.

*260-10-45-27*

Paragraphs 260-10-55-3 through 55-11 provide additional guidance on the application of the treasury stock method.

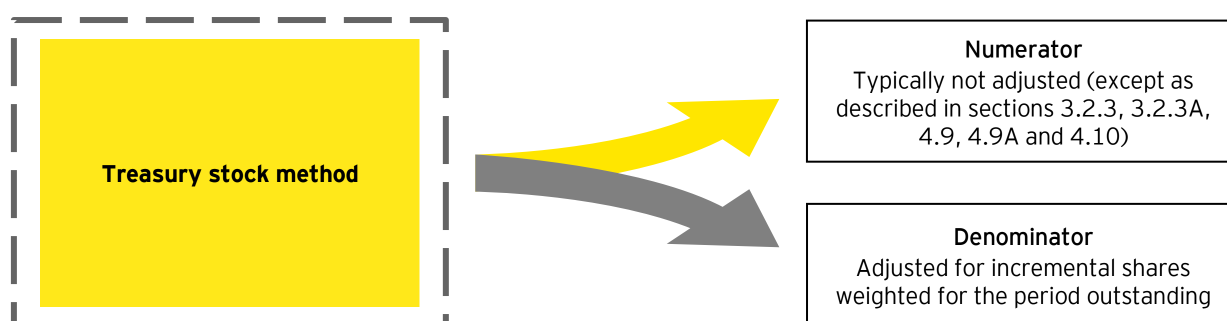
As discussed in ASC 260-10-45-25, options and warrants will have a dilutive effect under the treasury stock method only when the average price of the common stock during the period exceeds the exercise price of the options or warrants (i.e., they are "in-the-money"). Conversely, options and warrants will have an antidilutive effect when the average price of the common stock during the period is less than the exercise price (i.e., out-of-the-money). The graphic below summarizes this guidance:

If the average price does not exceed the exercise price in a reporting period, but in a subsequent period the average price increases above the option's exercise price, previously reported EPS data should not be adjusted retroactively as a result of changes in market prices of common stock.

If a forward sale contract must be settled through the issuance of shares regardless of whether it is in-the-money or out-of-the-money from the counterparty's perspective, we believe the treasury stock method should be applied to determine whether it results in dilution. That is, in contrast to options and warrants, an entity should not assume such a forward sale contract is antidilutive (and, therefore, exclude it from the diluted EPS calculation) solely because it is out-of-the-money.

Under ASC 260-10-45-26, the common shares issued upon exercise of dilutive options or warrants (or their equivalents) would be included in the denominator for basic and diluted EPS for the period after the exercise date as part of the weighted average shares outstanding. Incremental shares assumed issued under the treasury stock method should be weighted for the period the options or warrants (or their equivalents) were outstanding (in other words, prior to exercise, expiration or cancellation, and not before issuance if issued during the period) during the period for diluted EPS.

The numerator is typically not adjusted under the treasury stock method, except as described in sections 4.9 (before the adoption of ASU 2020-06), 4.9A (after the adoption of ASU 2020-06) and 4.10. In addition, Example 16 of ASC 260 (as discussed in sections 3.2.3 (before the adoption of ASU 2020-06) and 3.2.3A (after the adoption of ASU 2020-06)) notes there would be a numerator adjustment under the treasury stock method when a down round feature in certain equity-classified instruments is triggered. However, a numerator adjustment is not required in periods when options and warrants are out-of-the-money (i.e., zero shares are included in the denominator). The graphic below summarizes the adjustments made to the numerator and denominator when computing diluted EPS under the treasury stock method:




## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Applying the Treasury Stock Method*

*Options and Warrants and Their Equivalents*

*260-10-55-6*

**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.

*260-10-55-7*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-55-7*

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.

*260-10-55-8*

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**.

*260-10-55-9*

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.

*260-10-55-10*

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).

*260-10-55-11*

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.

ASC 260-10-55-6 through 55-11 provides additional guidance on how certain options and warrants (and their equivalents, such as forward sale contracts) should be included in the computation of diluted EPS.

Options or warrants to purchase convertible securities are assumed to be exercised to purchase the convertible security when 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 should not be assumed unless conversion of similar outstanding convertible securities, if any, is also assumed. The treasury stock method is applied to determine the incremental number of convertible securities that are assumed to be issued and immediately converted into common stock. Interest or dividends are not imputed on the incremental convertible securities because any imputed amount would be revised by the if-converted adjustments for assumed conversion.

If several conversion alternatives exist for one instrument, entities should include in their diluted EPS calculation the alternative that is the most advantageous to the option holder. Entities should do the same for preferred stock that has similar provisions or to other securities that have conversion options that allow the investor to pay cash for a more favorable conversion rate. When options or warrants allow or require the tendering of debt or other securities of the entity (or its parent or its subsidiary) as payment for all or a portion of the exercise price, it should be assumed that the if-converted method (see section 4.6) applies, unless tendering cash would be more advantageous to the option holder. In applying the if-converted method, the options or warrants are assumed to be exercised, and the debt or other securities are assumed to be tendered. Interest (net of tax) on any debt assumed to be tendered is added back as an adjustment to the numerator. The numerator also is adjusted for any nondiscretionary adjustments based on income (net of tax). If tendering cash would be more advantageous to the option or warrant holder, and the contract permits tendering cash, the treasury stock method is applied.

If the terms of the options or warrants require that the proceeds received from their exercise be applied to retire debt or other securities of the entity (or its parent or its subsidiary), the options or warrants are assumed to be exercised for the purpose of computing diluted EPS and the proceeds are assumed to be applied to purchase the debt at its average market price (rather than to purchase common stock under the treasury stock method). However, the treasury stock method is applied for any excess proceeds received from the assumed exercise. Interest (net of tax) on any debt assumed to be purchased is added back as an adjustment to the numerator. The numerator is also adjusted for any nondiscretionary adjustments based on income (net of tax).

Convertible securities that allow or require the payment of cash by the holder at conversion are considered the equivalent of warrants. In computing diluted EPS, the proceeds assumed to be received are assumed to be applied to purchase common stock under the treasury stock method and the convertible security is assumed to be converted under the if-converted method. Refer to Example 11 in ASC 260 (included in section 4.7.2 below) for guidance on the effects of contingently convertible instruments on diluted EPS.

## 4.3.1 Computing the average market price

**FASB amendment**

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The ASU made a consequential amendment to ASC 260-10-55-4 to delete the reference to the "treasury stock method." As discussed in section 4.1, ASU 2020-06 requires the use of the average share price to calculate the number of shares included in the denominator under both the treasury stock method and the if-converted method if the number of potential common shares is variable.

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Average Market Price*

*260-10-55-4*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*260-10-55-4*

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.

*260-10-55-5*

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 average market price must represent a meaningful average. We believe that many entities with a significant number of outstanding options, warrants and share-based payment awards will use a daily average of the closing market prices. However, ASC 260-10-55-4 acknowledges that, as a practical matter, a simple average of the weekly or monthly prices usually will be adequate. An entity should continue to use the same averaging convention unless it is no longer meaningful due to a change in conditions (e.g., the market price for a previously stable stock becomes volatile so the entity changes to a daily average from a weekly average).

In periods before the initial public offering (IPO), or other situations where market prices are limited or unavailable, determining the average market price of common stock may be more challenging. We have observed companies using the determination of the fair value of their shares, including contemporaneous valuations obtained from external specialists, during such periods. We generally would expect a company's fair value determination to be consistent with the fair value measurement of compensation cost for share-based payments and related disclosures and assumptions used to measure financial instruments indexed to the value of the company's shares.

## 4.3.2 Applying the treasury stock method in quarterly and year-to-date computations (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Applying the Treasury Stock Method*

*Year-to-Date Computations*

*260-10-55-3*

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.

*260-10-55-3A*

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.

*260-10-55-3B*

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.

Under the treasury stock method, quarterly diluted EPS is computed using the average market price (see section 4.3.1) during the three months in the reporting period. If there was a loss for the quarter, the effect of applying the treasury stock method generally would be antidilutive. That is, options and warrants are generally not included in the diluted EPS calculation because any incremental shares added to the denominator would result in a lower reported loss per share. However, see Question 4-1 in section 4.2 for a discussion of when potential common shares may be dilutive even when an entity is in a loss position.

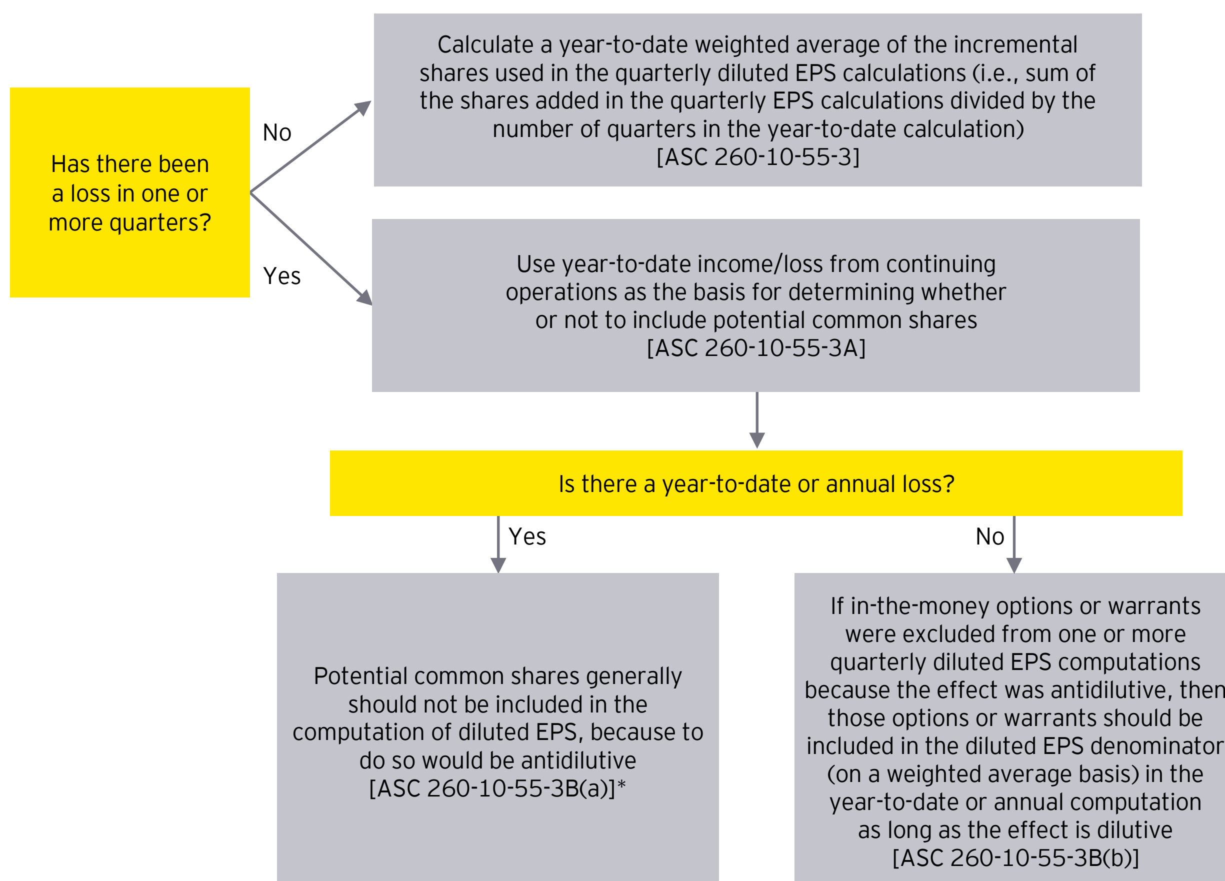
For year-to-date and annual computations when each period is profitable, the calculation builds off of the quarterly calculations. That is, the number of incremental shares added to the denominator is the weighted average of the incremental shares that were added to the denominator in each of the quarterly diluted EPS computations (i.e., the sum of the shares added in the quarterly diluted EPS calculations divided by the number of quarters in the year-to-date calculation or by four for the annual computation of diluted EPS).

For year-to-date and annual computations when one or more quarters has a loss, year-to-date and annual income (loss) from continuing operations should be used in determining whether in-the-money options or warrants are included in the denominator (i.e., whether they are dilutive). If the year-to-date or annual period has a loss, potential common shares are generally not included as they would be antidilutive. (See Question 4-1 in section 4.2 for a discussion of when potential common shares may be dilutive if an entity is in a loss position.) If the year-to-date or annual period has income, even if in-the-money stock options or warrants were excluded from the quarterly diluted EPS computation in one or more quarters because the effect was antidilutive, those options or warrants would be included in the denominator (on a weighted average basis) in the year-to-date or annual diluted EPS calculations as long as the effect is dilutive.

That is, under the treasury stock method, an entity would be required to calculate the number of incremental common shares that would have been included in each quarterly calculation of diluted EPS (if the effect is dilutive) and then include those incremental common shares in its weighted average year-to-date or annual denominator. This would also be the case for contingent shares that were excluded from a quarterly computation because they were antidilutive, unless the effect of including them would be antidilutive. As a result, diluted EPS for year-to-date and annual periods may not equal the sum of the diluted EPS amounts reported for each quarter.

Note that ASC 260-10-55-3A and 55-3B only discuss in-the-money options or warrants. As shown in Illustration 4-5 and Example 12 from ASC 260 below, if options or warrants were out-of-the-money in a quarterly reporting period (i.e., the exercise price was greater than the average price of the entity's common stock during the quarter) and therefore excluded from the quarterly diluted EPS denominator, no incremental common shares would be included in that quarter in the year-to-date weighted average calculation. We believe this would be the case even if those options or warrants would have been in-the-money using an average year-to-date share price.

The flowchart below illustrates this guidance when calculating the number of incremental shares to include in the denominator of year-to-date or annual diluted EPS calcuations using the treasury stock method:




* See Question 4-1 in section 4.2 for a discussion of when potential common shares may be dilutive even when an entity is in a loss position

For further discussion of quarterly and year-to-date computations under the treasury stock method, see Example 12 from ASC 260 and Illustration 4-5 below. Additionally, refer to Example 1 from ASC 260 in Appendix E.

## Excerpt from Accounting Standards Codification

**Earnings Per Share — Overall**

***Implementation Guidance and Illustrations***

***Example 12: Computing Year-to-Date Weighted-Average Shares Outstanding***

***260-10-55-85***

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*

*260-10-55-86*

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*

*260-10-55-87*

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.

**Illustration 4-5: The treasury stock method in quarterly and year-to-date calculations**

Assume that Company A is a calendar year company with 1,000,000 common shares outstanding for the full year and no discontinued operations (i.e., there is no difference between net income and income from continuing operations). For potential common shares, Company A has options for 200,000 shares outstanding for the entire year at an exercise price of $10.

**Consider the following scenarios:**

**Scenario 1** — Company A has a loss in the third quarter but income for all year-to-date periods. The average market price of the common stock was $20 for each of the four quarters (i.e., the options are in-the-money for the entire year).

| | Q1 | Q2 | Q3 | Q4 | Q4 YTD |
|---|---|---|---|---|---|
| Net income (loss) | $ 1,000,000 | $ 1,000,000 | $(1,000,000) | $ 1,000,000 | $ 2,000,000 |
| Weighted-average shares | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| **Basic EPS** | $ 1.00 | $ 1.00 | $ (1.00) | $ 1.00 | $ 2.00 |
| Incremental shares from options (a) | 100,000 | 100,000 | 0 (b) | 100,000 | 100,000 (c) |
| **Diluted EPS** | $ 0.91 | $ 0.91 | $ (1.00) | $ 0.91 | $ 1.82 (d) |

(a) There are 100,000 incremental shares for the options under the treasury stock method [(($20 average market price − $10 option price) / $20) x 200,000 options outstanding] in Q1, Q2 and Q4.

(b) Due to a loss for the period, zero incremental shares are included because the effect would be antidilutive. For this example, we are assuming there are no numerator adjustments.

(c) Twelve-month computation is [(100,000+100,000+100,000+100,000)/4] incremental shares related to the options under the treasury stock method. Even though the incremental shares related to the options were excluded from the Q3 calculation because of the loss for the quarter, the incremental shares are included on a weighted average basis in the annual computation because there is year-to-date income and the shares are dilutive to the annual diluted EPS calculation.

(d) Note that the full year diluted EPS is not equal to the sum of the quarters. The sum of the quarters is $1.73.

**Scenario 2** — Company A has a loss in the third quarter but income for all year-to-date periods, and the options were out-of-the-money during Q4 (i.e., the average stock price for that period fell below the strike price of the options).

| | Q1 | Q2 | Q3 | Q4 | Q4 YTD |
|---|---|---|---|---|---|
| Net income (loss) | $ 1,000,000 | $ 1,000,000 | $(1,000,000) | $ 1,000,000 | $ 2,000,000 |
| Weighted-average shares | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| **Basic EPS** | $ 1.00 | $ 1.00 | $ (1.00) | $ 1.00 | $ 2.00 |
| Incremental shares from options (e) | 100,000 | 100,000 | 0 | 0 | 75,000 (f) |
| **Diluted EPS** | $ 0.91 | $ 0.91 | $ (1.00) | $ 1.00 | $ 1.86 (g) |

(e) There are 100,000 incremental shares for the options under the treasury stock method [(($20 average market price − $10 option price) / $20) x 200,000 options outstanding] in Q1 and Q2. There are no incremental shares included for Q3 (due to the loss in Q3, assume no numerator adjustments) or Q4 (because the options were out-of-the-money in Q4).

(f) Twelve-month computation is [(100,000+100,000+100,000+0)/4] incremental shares related to the options. Even though the incremental shares related to the options were excluded from the Q3 calculation because of the loss for the quarter (assume no numerator adjustments), the incremental shares are included on a weighted average basis in the annual computation because there is year-to-date income and the shares are dilutive to the annual diluted EPS calculation. Because the options are out-of-the-money in Q4, we believe no incremental shares for the options are included in the year-to-date weighted average calculation for that quarter.

(g) Note that the annual diluted EPS is not equal to the sum of the quarters. The sum of the quarters is $1.82.

**Scenario 3** — The facts are the same as Scenario 1, except the loss in Q3 results in a Q3 year-to-date and annual loss.

| | Q1 | Q2 | Q3 | Q4 | Q4 YTD |
|---|---|---|---|---|---|
| Net income (loss) | $ 1,000,000 | $ 1,000,000 | $(4,000,000) | $ 1,000,000 | $(1,000,000) |
| Weighted-average shares | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| **Basic EPS** | $ 1.00 | $ 1.00 | $ (4.00) | $ 1.00 | $ (1.00) |
| Incremental shares from options (h) | 100,000 | 100,000 | 0 (i) | 100,000 | 0 (i) |
| **Diluted EPS** | $ 0.91 | $ 0.91 | $ (4.00) | $ 0.91 | $ (1.00) (j) |

(h) There are 100,000 incremental shares for the options under the treasury stock method [(($20 average market price − $10 option price) / $20) x 200,000 options outstanding] in Q1, Q2 and Q4. Based on discussions with the FASB staff, we believe diluted EPS for Q4 must include the dilutive effect of the options because there is profit for that quarter, despite the fact that it is now known that there is a loss for the year-to-date period.

(i) Due to a loss for the periods (both Q3 and Q4 year-to-date), zero incremental shares are included because the effect would be antidilutive (assume no numerator adjustments).

(j) Note that the full year diluted EPS is not equal to the sum of the quarters. The sum of the quarters is $(1.27).

## 4.4 Share-based payment arrangements

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Share-Based Payment Arrangements*

*260-10-45-28*

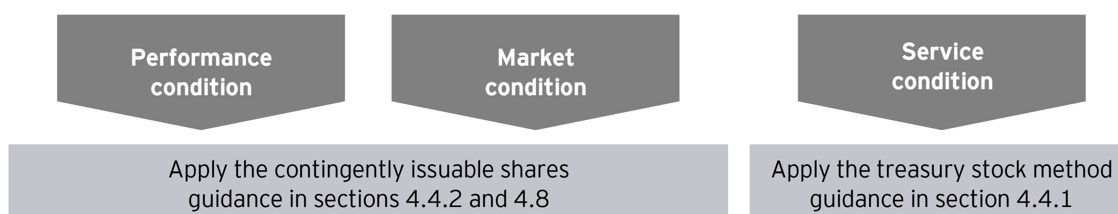
The provisions in paragraphs 260-10-45-28A through 45-31 apply to share-based awards issued to grantees under a share-based payment arrangement in exchange for goods and services or as consideration payable to a customer.

Share-based payments have several unique characteristics that can have a significant effect on EPS calculations. Under ASC 260, stock options and nonvested stock generally are not included in the calculation of basic EPS (even though nonvested stock may be legally outstanding). However, these equity awards are factored into the computation of *diluted* EPS using the treasury stock method. Further, in some cases, equity awards may be deemed participating securities and affect basic EPS as a result of the application of the two-class method (see section 5) or contingently issuable shares that are included in basic EPS as of the date that all necessary conditions have been satisfied (see further discussion in section 3.3.2).

The vesting provisions of an equity award determine how the award affects diluted EPS. Awards that vest or become exercisable based on the achievement of performance or market conditions (as defined in sections 3.4.3 and 3.4.4 of our FRD, ***Share-based payment***), are treated as contingently issuable shares (e.g., for nonvested stock) or contingently issuable potential common shares (e.g., for stock options) and are discussed in sections 4.4.2 and 4.8.

Share-based payments (whether stock options or shares) that vest based solely on the achievement of service conditions (as defined in section 3.4.2 of our FRD, ***Share-based payment***), are treated in a similar manner as options, using the treasury stock method and are discussed in section 4.4.1.

The graphic below summarizes how different vesting provisions are treated in the calculation of diluted EPS:




For purposes of calculating diluted EPS, nonvested stock that vests solely based on continued service is treated as the equivalent of an option grant that also is subject solely to service conditions. The treasury stock method is applied to determine the number of shares to be included in the denominator. Typically, there is no exercise price to be paid, so the proceeds are equal to the unrecognized compensation cost. Nonvested stock is to be considered outstanding as of the grant date for purposes of computing diluted EPS even though its issuance is contingent on future service vesting.

Nonvested stock is not included in basic EPS until the time-based vesting restriction has lapsed. However, see the discussion of the two-class method in section 5.4 for nonvested stock that pays nonforfeitable dividends during the vesting period.

## 4.4.1 Share-based payment awards — the treasury stock method (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Share-Based Payment Arrangements*

*260-10-45-28A*

Awards of share **options** and nonvested shares (as defined in Topic 718) to be issued to a grantee under a share-based payment 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).

*260-10-45-28B*

In applying the treasury stock method, all dilutive potential common shares, regardless of whether they are exercisable, are treated as if they had been exercised. The treasury stock method assumes that the proceeds upon exercise are used to repurchase the entity's stock, reducing the number of shares to be added to outstanding common stock in computing EPS.

*260-10-45-29*

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

The dilutive effect of outstanding awards of stock options and nonvested shares generally should be reflected in diluted EPS by applying the treasury stock method. Stock options will have a dilutive effect under the treasury stock method only when the average price of the common stock during the period exceeds the exercise price of the options (including the additions to the exercise proceeds discussed below). However, awards may not be dilutive even if the average market price exceeds the exercise price if, for example, the sum of the assumed proceeds (including unrecognized compensation cost) exceeds the difference between the market price and the exercise price.

The determination of whether the awards are dilutive should be made separately for quarterly and year-to-date calculations for each grant, not in the aggregate. If awards are not dilutive in one period but become dilutive in a subsequent period, previously reported EPS data is not retroactively adjusted as a result of changes in the market price of common stock.

Dilutive awards that are issued, expire or are canceled during a period should be included in the denominator of diluted EPS for the portion of the period that they were outstanding. Likewise, dilutive options exercised (or shares vested) during the period should be included in the denominator of diluted EPS for the period prior to actual exercise (or actual vesting).

The common shares issued when options are exercised (or shares are vested) are included in the denominator for basic and diluted EPS for the period after the exercise date (or the vest date), as part of the weighted average shares outstanding. Incremental shares assumed issued under the treasury stock method should be weighted for the period the awards were outstanding for diluted EPS.

Under ASC 718-740-35-2, all excess tax benefits and tax deficiencies are required to be recorded as income tax expense or benefit in the income statement when the awards vest or are settled. Therefore, when diluted EPS is computed using the treasury stock method, the assumed proceeds calculation excludes excess tax benefits and tax deficiencies.

Refer to Illustration 4-6 in section 4.4.2 for an example on the application of the treasury stock method to stock options. Example 8 from ASC 260 is also included in section 4.4.1.3.

We believe modifications of share-based payment awards generally should be treated as if there was a cancellation of the old award and the issuance of a new award when calculating diluted EPS. This treatment is consistent with the treatment of modifications accounted for under ASC 718-20-35-3 (see section 8.3 of our FRD, ***Share-based payment***), as well as ASC 260-10-45-28A that requires weighting of equity share options or other equity instruments that are outstanding for only part of a period. As a result, entities would have two separate treasury stock method calculations — one for the original awards through the date of modification and one for the modified awards beginning on the modification date — that both would be included in the calculation of diluted EPS, weighted for the period each was outstanding.

As previously discussed, how share-based payments affect diluted EPS depends on their vesting provisions. Awards that vest or become exercisable based on the achievement of performance or market conditions are treated as contingently issuable shares or contingently issuable potential common shares, as discussed

in section 4.4.2. Awards that vest based solely on the achievement of service conditions are treated similar to options using the treasury stock method, as discussed in section 4.4.1.1. Detailed guidance regarding the computation of (1) the average market price and (2) the application of the treasury stock method to quarterly and year-to-date diluted EPS calculations is included in sections 4.3.1 and 4.3.2, respectively.

### 4.4.1.1 Awards that vest based only on service conditions

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Share-Based Payment Arrangements*

*260-10-45-32*

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.

Awards subject only to service-based vesting should be considered outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent on satisfying a service condition. Although the numerator of the diluted EPS calculation may exclude compensation cost associated with awards that are not expected to vest (i.e., estimated forfeitures if the company elects to estimate forfeitures as discussed in section 4.4.1.3 of our FRD, ***Share-based payment***), the calculation of the denominator of the diluted EPS calculation described below includes the incremental common shares associated with all outstanding awards, including those that are expected to be forfeited. Section 4.4.1.2 includes a discussion of the effect of forfeitures on the computation of diluted EPS, and section 4.4.1.3 includes a discussion and an example of the effect of expected forfeitures on the assumed proceeds from option exercises used in the treasury stock method when calculating diluted EPS.

If awards were granted, exercised, forfeited or if they expired during the period, the shares issuable must be weighted to reflect the portion of the period during which the awards were outstanding.

When the treasury stock method is applied for awards, the assumed proceeds used to buy back shares at the average market price for the period would include the following (also see Example 8 from ASC 260 in section 4.4.1.3 which depicts this calculation):

**Any amount the grantee pays on exercise**

**Average amount of unrecognized compensation cost**

- If outstanding for the entire period — average amount is average of the beginning and ending amounts of unrecognized compensation cost for the period
- If outstanding for part of the reporting period — daily average of unrecognized compensation cost must be computed

Future compensation (i.e., compensation cost relating to nonvested or partially vested options that has been measured but has not yet been recognized as a cost in the financial statements) is considered part of assumed proceeds because it represents the future consideration a company expects to receive for the shares to be issued that has not been recognized in the financial statements, similar to the exercise price the employee must pay in cash. Compensation related to past services that already has been recognized as an expense is not considered part of the proceeds.

The treasury stock method must be applied separately to each award. For example, assumed proceeds from the awards that are antidilutive are not included in the treasury stock calculation for dilutive awards.

#### 4.4.1.2 Effect of forfeitures on diluted EPS

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Share-Based Payment Arrangements*

***260-10-45-29A***

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.

Compensation — Stock Compensation — Overall

*Other Presentation Matters*

***718-10-45-1***

Topic 260 requires that equity share options, **nonvested shares**, and similar equity instruments granted under share-based payment transactions be treated as potential common shares in computing diluted earnings per share (EPS). Diluted EPS shall be based on the actual number of options or shares granted and not yet forfeited regardless of the entity's accounting policy for forfeitures in accordance with paragraphs 718-10-35-1D and 718-10-35-3, unless doing so would be antidilutive. If **vesting** in or the ability to exercise (or retain) an **award** is contingent on a performance or **market condition**, such as the level of future earnings, the shares or share options shall be treated as contingently issuable shares in accordance with paragraphs 260-10-45-48 through 45-57. If 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 are outstanding.

ASC 260-10-45-28A (see section 4.4.1) provides that the shares issuable under a share-based payment arrangement must be weighted to reflect the portion of the period during which the share-based payment awards were outstanding. This requirement applies to actual forfeitures (and expired options) and to grants during the period. In addition, under ASC 260-10-45-29A, forfeitures do not affect the calculation of assumed proceeds under the treasury stock method until the forfeitures actually occur, despite the fact that forfeitures may be estimated for awards with service conditions for purposes of computing compensation cost under ASC 718 (see example in section 4.4.1.3 below). As discussed in section 4.4.1.3 of our FRD, ***Share-based payment***, a company may elect to account for forfeitures of awards with service conditions as they occur (e.g., when an employee leaves the company) or to estimate forfeitures and adjust the estimate when it is likely to change. The computation of diluted EPS is the same, regardless of the entity's accounting policy election for forfeitures for awards with service conditions.

### 4.4.1.3 Example calculation of the dilutive effect of employee stock options

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 8: Application of the Treasury Stock Method to a Share-Based Payment Arrangement*

*260-10-55-68*

This Example illustrates the guidance in paragraph 260-10-45-28A for the application of the treasury stock method when share options are forfeited.

*260-10-55-69*

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.

*260-10-55-69A*

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.

*260-10-55-70*

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 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).

Note that the average total unrecognized compensation cost in the above example could also have been calculated as follows (this alternative calculation is provided to illustrate the concept, but it would not be appropriate in other circumstances, such as when options are not outstanding for the entire reporting period or when an award is subject to graded vesting):

| | | |
|---|---|---|
| Beginning of period | (900,000 × $14.69) = | $ 13,221,000 |
| End of period | (900,000 options − 15,000 forfeited options) / 3 years vesting term × 2 years of remaining vesting = 590,000 × $14.69 fair value = | 8,667,100 |
| Subtotal | | 21,888,100 |
| Average total unrecognized compensation cost, based on actual forfeitures | | $ 10,944,050 |

## 4.4.2 Awards that vest or become exercisable based on the achievement of performance or market conditions (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Share-Based Payment Arrangements*

*260-10-45-31*

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.

*260-10-45-32*

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.

Share-based payments that vest or become exercisable based on the achievement of performance or market conditions are considered contingently issuable in the diluted EPS calculation (refer to section 4.8). A performance condition is a condition that is based on the operations or activities of the grantor or grantee. A market condition is a condition that relates to the achievement of: (1) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (2) a specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities). Performance and market conditions are discussed in greater detail in section 3 of our FRD, ***Share-based payment***.

Because performance and market conditions are considered contingencies under ASC 260, the criteria for contingently issuable shares must first be applied before determining the dilutive effect of these types of share-based payments. Before the end of the contingency period (i.e., before the performance or market conditions have been satisfied), the number of contingently issuable shares (for nonvested stock) or contingently issuable potential common shares (for stock options) to be included in diluted EPS should be based on the number of any shares that would be issuable under the terms of the arrangement using an assumption that the end of the reporting period was 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), assuming the result would be dilutive. Those contingently issuable shares or potential common shares should be included in the denominator of diluted EPS as of the beginning of the period or as of the grant date of the share-based payment, if later. The contingently issuable shares guidance is discussed in greater detail in sections 3.3.2 for basic EPS and 4.8 for diluted EPS.

When it is determined that potential common shares resulting from an award subject to performance or market conditions should be included in diluted EPS (based on the provisions discussed above), their effect on the computation of diluted EPS is reflected by applying the treasury stock method as previously described in section 4.4.1. Contingently issuable shares included in the diluted EPS denominator still may be subject to continued service vesting because only performance or market conditions are considered contingencies. Continued service vesting is not considered a contingency for purposes of calculating diluted EPS under ASC 260.

ASC 260's contingently issuable share provisions would be followed in computing diluted EPS, even if, for cost recognition purposes under ASC 718, it was deemed probable that a different number of shares would be issued than the number assumed to be issued for the diluted EPS computation. For example, assume that the award states that if earnings in 20X1 for Entity A (with a calendar year-end) exceed $1,000,000, options for 10,000 shares will vest. If earnings exceed $2,000,000, options for 40,000 shares ultimately will vest (the expected outcome). If earnings are $750,000 in the first quarter ended 31 March 20X1, none of the options would be assumed to be outstanding for diluted EPS. If at 30 June 20X1, year-to-date earnings are $1,600,000, the treasury stock method would be applied only to 10,000 incremental shares in the second quarter, even if compensation cost was recognized in both quarters based on the assumption that the 40,000 shares ultimately will vest. The EPS numerator would not be adjusted for this difference in approach between the diluted EPS treatment (ASC 260) and the determination of compensation cost (ASC 718). Under the contingently issuable share provisions of ASC 260, the remaining 30,000 options would not be included in the calculation until Entity A's earnings exceed $2,000,000.

Further, for awards subject to vesting or exercisability based on the achievement of market conditions (such as a target stock price), compensation cost is required to be recognized over the requisite service period under ASC 718, regardless of whether the market condition required for the option to become exercisable is achieved. However, under ASC 260, awards subject to vesting or exercisability based on the achievement of market conditions are treated as contingently issuable shares and included in the calculation of the denominator for diluted EPS only when the target stock price is met. To illustrate, assume 40,000 options will vest if the market price of Entity A's common stock exceeds $20 per share. The target stock price is not considered a performance condition under ASC 718, and compensation cost based on the fair value of the 40,000 options (inclusive of the effect of the market condition) must be recognized regardless of whether the market price threshold is met, as long as the requisite service is provided. However, for diluted EPS purposes, no additional shares will be assumed outstanding unless the target price is achieved.

The following illustrations depict the guidance discussed above for awards that vest or become exercisable based on the achievement of performance or market conditions:

**Illustration 4-6: Performance-based stock awards**

**Assume the following:**

- Entity A, a calendar year-end company, issued 10,000 nonqualified stock options to management on 1 January 20X1.
- The options vest at the end of five years. If earnings are less than $10,000,000 in 20X1, no options vest. If earnings are less than $15,000,000 but at least $10,000,000 in 20X1, 5,000 options vest. If 20X1 earnings equal or exceed $15,000,000, all 10,000 options vest at the end of the five-year period (provided that the employee continues to provide service through that date).
- The exercise price of the options is $6.
- The fair value of the options on the date of grant is $2.
- The average market price of Entity A's stock for the quarter ended 30 September 20X1 was $10 (only the third quarter is illustrated below).
- For the quarter ended 30 September 20X1, year-to-date earnings are $13,000,000, and therefore, 5,000 shares are issuable, assuming the total amount of year-to-date earnings remains unchanged.

For the quarter ended 30 September 20X1, the shares that would be included in the denominator for diluted EPS related to the stock options are calculated as follows:

**Proceeds:**

| | |
|---|---|
| Exercise price component (5,000 shares × $6) | $ 30,000 |
| Unrecognized compensation component [(5,000 × $2 × 18/20 quarters remaining) + (5,000 × $2 × 17/20 quarters remaining)] / 2 | 8,750 |
| Total assumed "proceeds" | $ 38,750 |
| Shares assumed repurchased ($38,750 / $10) | 3,875 |
| Incremental shares to be added (5,000 shares — 3,875 shares) | 1,125 |

In the above example, under ASC 260, diluted EPS is computed assuming 5,000 shares will be awarded, regardless of how many shares are used to compute compensation cost under ASC 718. If, as of the fourth quarter ended 31 December 20X1, annual earnings exceed $15,000,000 (as appears likely based on the earnings through 30 September 20X1), then the fourth quarter's diluted EPS computations will be based on 10,000 shares. However, this increase cannot be assumed for EPS purposes at 30 September 20X1. Further, diluted EPS cannot be retroactively adjusted when the quarter ended 30 September 20X1 is presented in the future after the $15,000,000 threshold has been surpassed.

**Illustration 4-7: Share-based payments with performance and market conditions**

**Assume the following:**

On 1 January 20X6, Company B (with a calendar year-end) grants a stock award with the following performance and market conditions:

- Performance condition — employees vest in 20%, 75% or 100% of 10,000 target shares based on Company B achieving net income for 20X6 of $200 million, $220 million or $250 million, respectively
- Market condition — awards are multiplied by (1) 50% if Company B's annual total shareholder return (TSR) in 20X6 is in the bottom half of its peer group or (2) 200% if Company B's annual TSR in 20X6 is in the top half of its peer group

As of Q3 20X6, net income is $205 million and year-to-date TSR is in the bottom half of Company B's peer group.

As of 20X6 year-end, net income is $230 million and annual TSR is in the top half of Company B's peer group.

| Quarter-to-date EPS | Include in the calculation of basic weighted average shares outstanding | Include in the calculation of diluted EPS using the treasury stock method |
|---|---|---|
| **Q3 20X6** | 0* | 10,000 x 20% x 50% = 1,000 |
| **Q4 20X6** | 10,000 x 75% x 200% = 15,000 | 10,000 x 75% x 200% =15,000 |

* Because a loss in Q4 could cause annual net income to fall below $200 million, all conditions have not yet been satisfied, and the shares are excluded from basic EPS (i.e., zero shares vest if annual net income is less than $200 million) in Q3.

In Q3 20X6 in the above example, all conditions have not yet been satisfied because a loss in Q4 could cause annual net income to fall below $200 million. Therefore, the shares are excluded from basic EPS in Q3. In Q3, for diluted EPS, shares are included based on the assumption that the end of the reporting period was the end of the contingency period. Based on Q3 net income, 20% of the 10,000 target shares would be issued. Those shares would be multiplied by 50% based on the TSR, resulting in 1,000 shares assumed to be issued. These shares would be included in the denominator of diluted EPS using the treasury stock method.

In Q4, because the end of the contingency period is 31 December 20X6, the shares are no longer contingently issuable and are included in the denominator (weighted average shares outstanding) of basic EPS for one day. Based on 20X6 net income, 75% of the 10,000 target shares would be issued, and those shares would be multiplied by 200% based on the TSR compared to the relevant peer group, resulting in 15,000 shares issued. For diluted EPS, the same number of shares would be included using the treasury stock method for the period up until the contingency is met.

### 4.4.3 Profits interests (updated September 2024)

As discussed in section 5.2.8 of our FRD, ***Share-based payment***, profits interests are frequently issued by pass-through entities, such as a partnership, a limited liability partnership (LLP) and a limited liability company (LLC). While the term "profits interest" is not defined in US GAAP, these awards generally give the grantee an opportunity to participate in future profits and/or equity appreciation of the entity but do not give them rights to existing net assets of the entity. Profits interests should be evaluated to determine whether the awards should be accounted for as equity interests under ASC 718 or as performance bonuses or profit-sharing arrangements under ASC 710. If an entity has determined that profits interests should be accounted for as equity interests under ASC 718, the entity should consider the EPS considerations for share-based payment awards discussed in section 4.4. In addition, profits interests may meet the definition of a participating security (e.g., if they are entitled to nonforfeitable dividends) to which the two-class method of EPS should be applied (see section 5).

## 4.5 Employee stock ownership plans and employee stock purchase plans

### 4.5.1 Employee stock ownership plans

Employee stock ownership plans (ESOPs) are US tax-qualified employee stock benefit plans designed to invest primarily in the stock of the sponsoring corporation. In effect, an ESOP is a deferred compensation plan (defined contribution pension plan) similar to a profit-sharing plan in that each participant has a separate account. Periodic employer contributions and plan earnings are allocated to those separate accounts. However, ESOP benefits usually are distributable in stock of the employer, which is not always the case with profit-sharing plans.

ASC 718-40 provides guidance on the accounting for ESOPs, including EPS considerations depending on whether the plan is leveraged or nonleveraged, as follows:

**Excerpt from Accounting Standards Codification**

**Compensation — Stock Compensation — Employee Stock Ownership Plans**

*718-40-05-3*

*Overview and Background*

*Leveraged Employee Stock Ownership Plans*

A leveraged **employee stock ownership plan** borrows money to acquire shares of the employer stock. The money can be borrowed by the employee stock ownership plan from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the employee stock ownership plan are generally guaranteed by the sponsor. Unlike other kinds of employee benefit plans, an employee stock ownership plan is permitted by Employee Retirement Income Security Act of 1974 to borrow from a related party or with the assistance of a related party. The debt usually is collateralized by the employer's shares.

*718-40-05-4*

*Nonleveraged Employee Stock Ownership Plans*

As indicated in paragraph 718-40-25-21, an employer with a nonleveraged **employee stock ownership plan** periodically contributes its shares or cash to its employee stock ownership plan on behalf of employees. In the case of cash contributions the entity acquires shares. The shares are allocated to participant accounts and held by the employee stock ownership plan until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged employee stock ownership plan shall be allocated to individual participant accounts as of the end of the employee stock ownership plan's fiscal year. Allocating shares by year end is mandated by the tax code in 2008. The Codification does not keep up with changes in the tax code.

*Other Presentation Matters*

*General*

*EPS*

*718-40-45-1*

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).

*Issuance of Shares or the Sale of Shares to an Employee Stock Ownership Plan*

*718-40-45-2*

Paragraph 718-40-25-10 states that an employer shall report the issuance of shares or the sale of treasury shares to an employee stock ownership plan when they occur and shall report a corresponding charge to unearned employee stock ownership plan shares, a contra-equity account. That account should be presented as a separate item in the balance sheet.

*Leveraged Employee Stock Ownership Plans*

*EPS*

*718-40-45-3*

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.

*718-40-45-4*

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.

*718-40-45-5*

Prior period EPS shall not be restated for changes in the conversion rates.

*Convertible Preferred Shares*

*718-40-45-6*

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.

*718-40-45-7*

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.

*718-40-45-8*

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*

*718-40-45-9*

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.

See section 7.2.2 for disclosures required by ASC 718-40. ASC 718-40 also includes two examples of leveraged ESOPs and one of a nonleveraged ESOP.

SOP 76-3 (which was superseded by SOP 93-6 and is now codified in ASC 718-40) continues to apply to ESOP shares purchased by, and held as of, 31 December 1992. Under SOP 76-3, all shares purchased and held by an ESOP as of 31 December 1992 are considered outstanding for purposes of computing both basic and diluted EPS. That is, it does not distinguish between leveraged and nonleveraged ESOPs.

### 4.5.2 Employee stock purchase plans (updated August 2023)

Employee stock purchase plans (ESPPs) generally provide a broad group of employees the right to acquire employer stock through payroll deductions. A typical plan (e.g., one that qualifies under Section 423 of the Internal Revenue Code, also known as a "Section 423 Plan") allows employees to buy the employer's stock at a discount from the market price at the date of grant over a period of time (e.g., two years), usually through payroll deductions.

Shares issued under ESPPs are outstanding shares and are included in the calculation of both basic and diluted EPS. However, ASC 260 does not provide specific guidance on how to calculate the EPS effect of ESPPs before share issuance. Historical practice has been to follow ASC 260's contingently issuable shares guidance (discussed in section 4.4.2 with respect to performance and market conditions). In the case of ESPPs, we believe that the contingency is the employees' payment of funds through payroll withholdings (effectively the "acceptance" of the employer's "offer" of shares or options). As a result, we believe that the shares or options contingently issuable do not affect EPS until the respective payroll amounts are withheld.

As previously indicated, most ESPPs have a withholding feature under which the employer deducts an agreed amount from the participating employee's pay and, after a specified period of time, the accumulated cash is used to purchase shares. We believe that whether the withholding of cash compensation to purchase shares is considered an option (in which case the treasury stock method is applied to compute diluted EPS) or contingently issuable shares depends on whether the withheld amounts are refundable. If refunds are permitted, we believe that the substance of the plan is that options are issued to the employee each pay period as salary is withheld. If withheld amounts are not refundable, but employees authorize withholding of wages and salaries to be used to purchase stock at a designated future date, we believe that the shares currently purchasable with the amounts withheld should be included in weighted average shares outstanding for both basic and diluted EPS.

We understand that other interpretations of how to calculate the dilutive effect of ESPPs exist. Specifically, we are aware of an alternative view under which the withholding of cash is not considered a contingency or acceptance of an offer of shares or options. According to this view, the dilutive effect of the ESPP is calculated considering all the funds to be withheld during the purchase period (similar to the valuation of an ESPP award under ASC 718-50), not just the funds that have been withheld to date. Under this alternative method, the calculation of the assumed proceeds used to "buy back" shares under the treasury stock method would include the average unrecognized compensation cost for the award, thereby limiting the dilutive effect of the award (note that the average unrecognized compensation cost is not included in the calculation described in the preceding paragraph because it relates to shares to be purchased with future withholdings, which are excluded from the EPS calculation in the preceding paragraph). We believe this interpretation of how to calculate the EPS effect of ESPPs also is acceptable.

Before the adoption of ASU 2020-06, regardless of the method used to calculate the dilutive effect of ESPPs, the determination of the incremental number of shares to be added to the diluted EPS calculation for plans with "look-back" options should consider the share price at the end of the reporting period (which is consistent with the guidance on contingently issuable shares in ASC 260-10-45-52). For example, if the plan provides the employee the right to purchase shares at 85% of the lower of the grant date share price or the purchase date share price, the calculation of the number of shares issued in the treasury stock calculation should be based on a purchase price of 85% of the lower of the grant date share price or the share price at the end of the reporting period.

After the adoption of ASU 2020-06, we believe there are two acceptable methods to compute the number of incremental shares issuable under the ESPP. Entities can either follow the contingently issuable shares guidance (which reflects historical practice before adoption of ASU 2020-06 discussed above) or use the average market price during the period as discussed in ASC 260-10-45-21A (which was added by ASU

2020-06). ASC 260-10-45-21A (see section 4.1) requires the use of an average market price to calculate the diluted EPS denominator under the treasury stock method or the if-converted method if the number of potential common shares is variable (e.g., when changes in the entity's share price affect the number of shares that may be used to settle a financial instrument). The method selected by an entity should be consistently applied.

## 4.6 Convertible securities and the if-converted method (updated August 2023)

**FASB amendment**

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The guidance requires entities to use the if-converted method to calculate diluted EPS for all convertible instruments. Under legacy GAAP, the treasury stock method is used to calculate the dilutive effect on EPS for some convertible instruments (e.g., convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash but may settle the conversion premium in cash or shares as discussed in section 4.9.1). The guidance also modifies ASC 260-10-45-40(b)(1) (shown as pending content below) so that interest charges on convertible debt for which the principal is required to be paid in cash would not be added back to the numerator. ASC 260-10-45-40(c) is also changed to refer to the new guidance on variable denominators in ASC 260-10-45-21A (included in section 4.1).

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Convertible Securities and the If-Converted Method*

*260-10-45-40*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*260-10-45-40*

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).

*260-10-45-41*

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.

*260-10-45-42*

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.

Debt and preferred stock that are convertible (either optionally or mandatorily) into common stock could result in the issuance of common shares. The effect of these potential common shares on diluted EPS calculations generally is determined by using the if-converted method.[7] This method recognizes that the holders of convertible debt or convertible preferred stock cannot share in distributions of earnings available to common shareholders unless they relinquish their right to senior distributions (i.e., interest income or preferred dividends). Under the if-converted method:

- For *convertible debt* outstanding, in accordance with ASC 260-10-45-40(b), an entity should (1) add back to the numerator any interest expense (including accretion of discounts or amortization of premiums, as well as amortization of debt issuance costs) recognized on the convertible debt, (2) adjust the numerator appropriately if nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized (e.g., expense associated with a profit sharing plan or a royalty agreement) and (3) adjust the numerator for the income tax effect, if any, of (1) and (2).

  However, after the adoption of ASU 2020-06, an entity should *not* add back to the numerator interest expense for convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash (e.g., Instruments B and C discussed in section 4.9.1A). As discussed in the Basis for Conclusions of ASU 2020-06,[8] since the Board decided to align the diluted EPS calculation for convertible instruments and eliminate the use of the treasury stock method for these instruments, continuing to require entities to add back interest expense after they adopt the ASU would provide a confusing diluted EPS result. This is because an entity would not have avoided the cash payment of interest just because the principal and interest are required to be cash settled. The Board noted that, under the new guidance, the diluted EPS result under the if-converted method for a convertible instrument where, upon conversion, the issuer must pay the principal in cash will be similar to the diluted EPS result under legacy GAAP when applying the treasury stock method.

  Entities should also reverse any gains or losses recognized on actual (not hypothetical) settlements of convertible debt that occurred during the period. That is, it is necessary to remove from the numerator any effects the convertible securities may have had during the period to be consistent with the assumption of the if-converted method that the securities were converted as of the beginning of the period.

- For *convertible preferred stock*, ASC 260-10-45-40(a) states that preferred dividends should be added back to the numerator.[9] The amount of preferred dividends added back or other adjustments would be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations attributable to the parent entity and from net income attributable to the parent entity in computing income available to common stockholders. This would include any amounts treated like preferred stock dividends as discussed in section 3.2.1 related to redemption or conversion of preferred stock and section 3.2.2 related to changes in the carrying value of certain redeemable preferred stock.

  While this is not stated in ASC 260, for similar reasons to convertible debt above, we believe that for convertible preferred stock for which the liquidation preference must be paid in cash, an entity should not add back preferred dividends to the numerator. Also similar to the requirements for convertible debt, entities should adjust the numerator appropriately if nondiscretionary adjustments based on income made during the period would have been computed differently had the dividends on preferred stock never been recognized.

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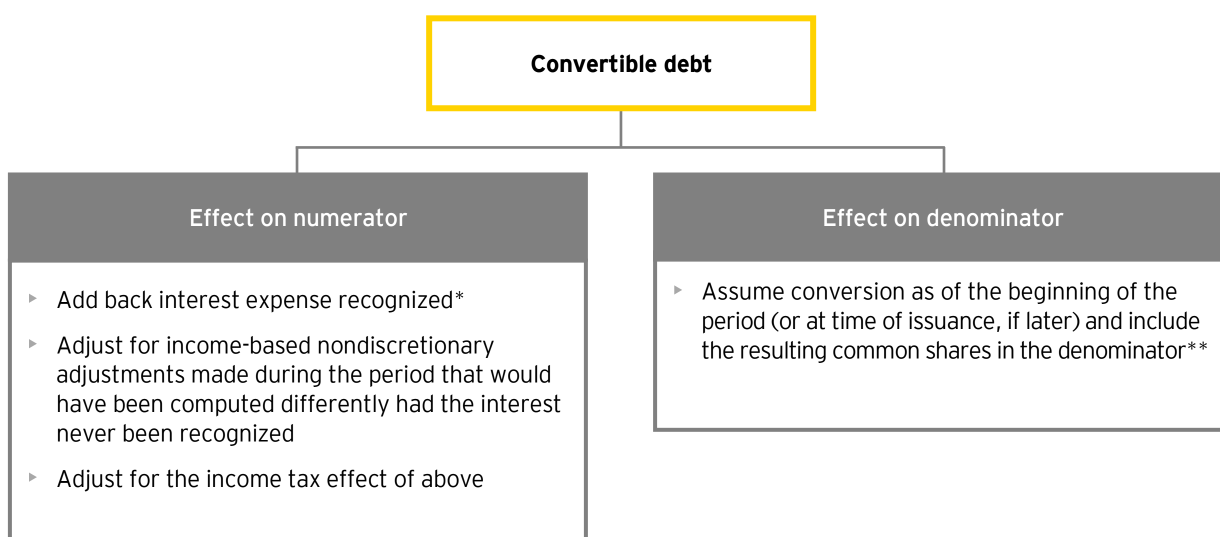
[7] For certain contingently convertible securities, the if-converted method is not applied until the contingent event occurs and the security becomes convertible (see section 4.7). Additionally, before the adoption of ASU 2020-06, for convertible debt securities that upon conversion require the accreted value of the instrument to be settled in cash and permit the excess conversion value to be settled in cash or shares, the if-converted method does not apply (see section 4.9.1). However, after the adoption of ASU 2020-06, for such convertible debt securities, the if-converted method is required to be used for calculating diluted EPS.

[8] Paragraphs BC110 and BC111 of ASU 2020-06.

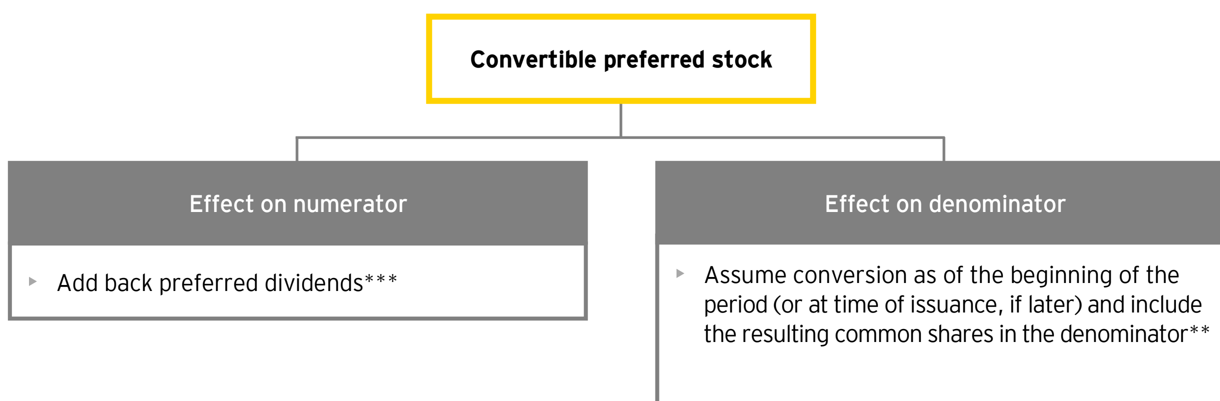
[9] Preferred dividends are only added back for diluted EPS when the preferred stock is convertible. Nonconvertible preferred stock dividends reduce income available to common stockholders for both basic and diluted EPS.

- Under ASC 260-10-45-40(c), the convertible preferred stock or convertible debt should be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares should be included in the denominator. If the number of incremental shares that may be issued is variable (e.g., due to changes in the conversion ratio resulting from changes in the underlying common stock price), there is diversity in practice before the adoption of ASU 2020-06 on what share price is used to calculate the number of incremental shares under the if-converted method (see section 4.6.1). After the adoption of ASU 2020-06, if the number of incremental shares is variable, an entity would apply the guidance in ASC 260-10-45-21A (see sections 4.1 and 4.6.1A) and use the average share price in this calculation.

The graphic below summarizes the diluted EPS effects on the numerator and denominator for convertible debt under the if-converted method, consistent with ASC 260-10-45-40:




The following graphic summarizes the diluted EPS effects on the numerator and denominator for convertible preferred stock under the if-converted method, consistent with ASC 260-10-45-40:




* After the adoption of ASU 2020-06, for convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash, interest expense should not be added back to the numerator. This type of convertible debt instrument is commonly referred to as Instrument C in practice. Refer to section 4.9.1A (after the adoption of ASU 2020-06) for further discussion of Instrument C.

** If the number of incremental shares is variable, see section 4.6.1 (before the adoption of ASU 2020-06) or section 4.6.1A (after the adoption of ASU 2020-06).

*** After the adoption of ASU 2020-06, for convertible preferred shares where, upon conversion, the issuer must pay the liquidation preference in cash, preferred dividends should not be added back to the numerator.

As discussed above, in addition to the numerator adjustments specifically mentioned in ASC 260-10-45-40 (and depicted in the graphic above), an entity may need to make other adjustments to remove from the numerator any effects the convertible securities may have had during the period to be consistent with the assumption of the if-converted method that the securities were converted as of the beginning of the period. Examples of these adjustments that may be made to the numerator, including those mentioned in ASC 260-10-45-40, include:

| | |
|---|---|
| **Convertible debt:** | Add back interest expense recognized |
| | Reversal of any accretion of discounts or amortization of premiums, as well as amortization of debt issuance costs |
| | Reversal of any gains or losses recognized on actual (not hypothetical) settlement |
| | Reversal of any mark-to-market adjustments (refer to sections 4.9 and 4.9A) |
| | Adjust for income-based nondiscretionary adjustments made during the period that would have been computed differently if the interest expense and other items had not been recognized |
| | Adjust for the income tax effect of above |
| **Convertible preferred stock:** | Add back preferred dividends |
| | Reversal of any amounts treated like preferred stock dividends as discussed in section 3.2.1 related to redemption or conversion of preferred stock and/or section 3.2.2 related to changes in the carrying value of certain redeemable preferred stock |
| | Reversal of any mark-to-market adjustments (refer to sections 4.9 and 4.9A) |
| | Adjust for income-based nondiscretionary adjustments made during the period that would have been computed differently if the dividends on preferred stock and other items had not been recognized |
| | Adjust for the income tax effect of above |

In applying the if-converted method, conversion should not be assumed for purposes of computing diluted EPS if the effect would be antidilutive. As discussed in ASC 260-10-45-41, convertible preferred stock is antidilutive if the amount of the dividend declared in (or accumulated for) the current period per common share, obtainable on conversion, is greater than basic EPS. Similarly, convertible debt is antidilutive whenever its interest (net of tax and nondiscretionary adjustments) per common share, obtainable upon conversion, is greater than basic EPS. That is, convertible securities, unlike options and warrants under the treasury stock method discussed in section 4.3, are included in the calculation of diluted EPS even when they are out-of-the-money (e.g., the conversion price exceeds the entity's stock price) if the result is dilutive to EPS.

Dilutive convertible securities that are outstanding for a portion of a period, because, for example, they are issued during the period, conversion options lapse, preferred stock is redeemed or related debt is extinguished, should be included in the denominator of diluted EPS for the actual period that they were outstanding.

Likewise, dilutive convertible securities converted during a period should be included in the denominator for the period prior to actual conversion. The numerator is adjusted as discussed above. The common shares issued upon actual conversion should be included in the denominator for the period after the date of conversion for both basic and diluted EPS. Consequently, shares assumed issued are weighted for the period the convertible securities were outstanding, and common shares actually issued are weighted for the period the shares were outstanding.

The illustration below provides an example of the computation of diluted EPS using the if-converted method.

**Illustration 4-8: Dilutive effect of convertible debt under the if-converted method**

Company A has income from continuing operations of $4,000,000, and the weighted average number of shares outstanding is 3,300,000 for the year ended 20X1. Convertible (4%) debentures with a principal amount of $10,000,000 due in 10 years were issued for cash in 20X0 at $1,000 (par). Each $1,000 debenture is convertible into 50 shares of common stock. No debentures were converted during 20X0 or 20X1. The tax rate was 40% for 20X1. The calculation of diluted EPS for the year ended 20X1 is illustrated below.

| | Income from continuing operations | Weighted average shares outstanding | Diluted EPS |
|---|---|---|---|
| Unadjusted amounts | $ 4,000,000 | 3,300,000 | $ 1.21 |
| Interest effect of convertible (4%) debentures | 240,000 (a) | 500,000 (b) | 0.48 (c) |
| Adjusted amounts | $ 4,240,000 | 3,800,000 | $ 1.12 |

(a) ($10,000,000 principal amount x 4%) less income taxes of 40%.

(b) ($10,000,000 principal amount / $1,000 par value) x 50 common shares.

(c) Convertible debt is dilutive whenever its interest (net of tax) per common share assuming conversion is less than basic EPS (unadjusted amounts above).

## 4.6.1 Variable conversion prices (before adoption of ASU 2020-06)

This section addresses variable conversion prices before the adoption of ASU 2020-06. For discussion after the adoption of ASU 2020-06, see section 4.6.1A.

Some convertible securities include conversion prices that change based on the underlying common stock's market price. For periods when the conversion price is not fixed, we believe that the conversion price can be determined in one of two ways for purposes of the if-converted calculation:

- Based on the end of the period market price, consistent with the guidance in ASC 260-10-45-52 for contingently issuable shares (see section 4.8)
- Based on the average share price during the period, as illustrated in Case B of Example 11 of ASC 260 (i.e., ASC 260-10-55-84 through 55-84B for contingently convertible debt with a market price trigger (see section 4.9.1)

Entities should select an accounting policy in this regard and apply that policy consistently to all similar instruments.

## 4.6.1A Variable conversion prices (after adoption of ASU 2020-06)

This section addresses variable conversion prices after the adoption of ASU 2020-06. For discussion before the adoption of ASU 2020-06, see section 4.6.1.

## FASB amendment

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The guidance requires the use of the average share price to calculate the number of shares included in the denominator under both the treasury stock method and the if-converted method if the number of potential common shares is variable.

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

### Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Other Presentation Matters*

*Computation of Diluted EPS*

#### Pending Content:

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*Variable Denominator*

*260-10-45-21A*

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.

As discussed in section 4.1, ASC 260-10-45-21A (after the adoption of ASU 2020-06) requires entities to use an average market price to calculate the denominator of the diluted EPS calculation under the if-converted method when the number of potential common shares is variable, such as when (1) the exercise price may change based on entity's share price or (2) changes in the entity's share price may affect the number of shares used to settle a financial instrument. As noted in the Basis for Conclusions of ASU 2020-06,[10] this requirement is intended to reduce diversity in practice (as identified in section 4.6.1) under the if-converted method and is consistent with the existing requirements in ASC 260-10-55-4 through 55-5 (see section 4.3.1) under the treasury stock method. The Board decided that using an average share price provides the most consistent calculations for the if-converted method because an average price would be less volatile than a price determined at a point in time.

As noted in ASC 260-10-45-21A, this guidance does not apply to contingently issuable shares in the scope of ASC 260-10-45-48 through 45-57 (see section 4.8).

[10] Paragraph BC115 of ASU 2020-06.

### 4.6.2 Applying the if-converted method in quarterly and year-to-date computations (updated August 2023)

Under the if-converted method, in accordance with ASC 260-10-45-40(c) (see section 4.6), convertible securities are assumed to be converted as of the beginning of the period (or at time of issuance, if later) and the resulting common shares are included in the diluted EPS denominator, if dilutive (after also considering any numerator adjustments).

If an entity incurs a loss from continuing operations in a quarter, similar to the application of the treasury stock method discussed in section 4.3.2, potential common shares are generally not included in the diluted EPS calculation for the loss quarter because to do so would be antidilutive (i.e., incremental shares added to the denominator would results in a lower reported loss per share). However, in some cases, a company may have convertible securities that are dilutive due to a required numerator and denominator adjustment (e.g., an instrument that can be settled in cash or shares and is asset- or liability-classified but is assumed to be settled in shares for EPS purposes) even when the company has a net loss. See Question 4-1 in section 4.2 for further discussion.

For year-to-date and annual diluted EPS calculations when one or more quarters has a loss, the year-to-date or annual income (or loss) from continuing operations, as applicable, is used to decide whether convertible securities are included in the denominator (i.e., if they are dilutive or not). Even if certain convertible securities were excluded from one or more quarters for computing quarterly diluted EPS because they were antidilutive, they would be included in year-to-date or annual diluted EPS calculations as long as they are dilutive. Accordingly, diluted EPS for year-to-date and annual periods may not equal the sum of the quarters' diluted EPS amounts.

As discussed in section 4.6, dilutive convertible securities that are outstanding for a portion of a period, because, for example, they are issued during the period, conversion options lapse, preferred stock is redeemed or related debt is extinguished, should be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive convertible securities converted during a period should be included in the denominator of the diluted EPS calculation for the period prior to conversion. The common shares issued upon conversion should be included in the denominator for the period after the date of conversion for both basic and diluted EPS. That is, for calculations of year-to-date and annual diluted EPS, dilutive convertible securities are weighted for the period of time they were outstanding in that period. This differs from the calculation under the treasury stock method discussed in section 4.3.2, in which a weighted average of each quarterly calculation is calculated, as required by ASC 260-10-55-3.

The following example illustrates how if-converted method is applied to year-to-date and annual diluted EPS calculations when one of the quarters has a loss from continuing operations:

**Illustration 4-9: The if-converted method in quarterly and year-to-date calculations**

Assume that Company A is a calendar year company with 1,000,000 common shares outstanding for the full year and no discontinued operations (i.e., there is no difference between net income and income from continuing operations). For potential common shares, Company A has convertible preferred stock outstanding that is convertible at the option of the holder. Each preferred share is convertible into one common share. No dividends were declared, and the dividends are not cumulative (thus, for this example, there is no effect on the numerator).

**Consider the following scenarios:**

**Scenario 1** — Company A has a loss in the third quarter but income for all year-to-date periods and 200,000 shares of convertible preferred stock outstanding for the entire year.

| | Q1 | Q2 | Q3 | Q4 | Q4 YTD |
|---|---|---|---|---|---|
| Net income (loss) | $ 1,000,000 | $ 1,000,000 | $(1,000,000) | $ 1,000,000 | $ 2,000,000 |
| Weighted-average shares | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| **Basic EPS** | $ 1.00 | $ 1.00 | $ (1.00) | $ 1.00 | $ 2.00 |
| Incremental shares from conversion of preferred | 200,000 | 200,000 | 0 (a) | 200,000 | 200,000 (b) |
| **Diluted EPS** | $ 0.83 | $ 0.83 | $ (1.00) | $ 0.83 | $ 1.67 (c) |

(a) Due to a loss for the period, zero incremental shares are included because the effect would be antidilutive.

(b) For the 12-month computation of diluted EPS, 200,000 incremental shares are added to the denominator for the convertible preferred stock under the if-converted method (i.e., assume that the preferred shares were converted into common stock as of the beginning of the year), even though there is a net loss during the third quarter.

(c) Note that the full year diluted EPS is not equal to the sum of the quarters. The sum of the quarters is $1.49.

**Scenario 2** — Company A has a loss in the third quarter but income for all year-to-date periods. In addition, 150,000 shares of the 200,000 shares of convertible preferred stock outstanding as of the beginning of the year were converted on 1 May (one month into Q2).

| | Q1 | Q2 | Q3 | Q4 | Q4 YTD |
|---|---|---|---|---|---|
| Net income (loss) | $ 1,000,000 | $ 1,000,000 | $(1,000,000) | $ 1,000,000 | $ 2,000,000 |
| Weighted-average shares | 1,000,000 | 1,100,000 (d) | 1,150,000 (d) | 1,150,000 (d) | 1,100,000 (e) |
| **Basic EPS** | $ 1.00 | $ 0.91 | $ (0.87) | $ 0.87 | $ 1.82 (f) |
| Incremental shares from conversion of preferred | 200,000 | 100,000 (g) | 0 (h) | 50,000 (g) | 100,000 (i) |
| **Diluted EPS** | $ 0.83 | $ 0.83 | $ (0.87) | $ 0.83 | $ 1.67 (j) |

(d) On 1 May, 150,000 shares converted. Therefore, the weighted average shares included in the denominator for Q2 is 1,100,000 or [(1,000,000 (April) + 1,150,000 (May) + 1,150,000 (June)) / 3]. In Q3 and Q4, there are no additional conversions or issuances, therefore the weighted average shares included in the denominator for Q3 and Q4 is 1,150,000.

(e) The weighted average shares included in the denominator for year-to-date basic EPS in Q4 is calculated as ((1,000,000 x (4/12) + (1,150,000 x (8/12)). This is consistent with Example 1 of ASC 260 (see Appendix E).

(f) Note that the full year basic EPS is not equal to the sum of the quarters. The sum of the quarters is $1.91.

(g) On 1 May, 150,000 shares converted. Therefore, the number of incremental shares included in the denominator for Q2 is 100,000 or (200,000 + 50,000 + 50,000) / 3). For all of Q4, there are 50,000 remaining convertible shares outstanding.

(h) Due to a loss for the period, zero incremental shares are included because the effect would be antidilutive.

(i) For the 12-month computation of diluted EPS, 100,000 additional shares are added to the denominator for the convertible preferred stock under the if-converted method, calculated as (200,000 x 4/12) + (50,000 x 8/12). This is consistent with Example 1 of ASC 260 (see Appendix E).

(j) Note that the full year diluted EPS is not equal to the sum of the quarters. The sum of the quarters is $1.62.

**Scenario 3** — Company A has a loss in the third quarter that results in a full-year loss and 200,000 shares of convertible preferred stock outstanding for the entire year.

| | Q1 | Q2 | Q3 | Q4 | Q4 YTD |
|---|---|---|---|---|---|
| Net income (loss) | $ 1,000,000 | $ 1,000,000 | $(4,000,000) | $ 1,000,000 | $(1,000,000) |
| Weighted-average shares | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| **Basic EPS** | $ 1.00 | $ 1.00 | $ (4.00) | $ 1.00 | $ (1.00) |
| Incremental shares from conversion of preferred | 200,000 | 200,000 | 0 (k) | 200,000 (l) | 0 (k) |
| **Diluted EPS** | $ 0.83 | $ 0.83 | $ (4.00) | $ 0.83 | $ (1.00) (m) |

(k) Due to a loss for the periods (both Q3 and year-to-date), zero incremental shares are included because the effect would be antidilutive.

(l) Based on discussions with the FASB staff, we believe diluted EPS for Q4 must include the dilutive effect of the options and convertible debt because there is a profit for that quarter, despite the fact that it is now known that there is a loss for the year.

(m) Note that the full year diluted EPS is not equal to the sum of the quarters. The sum of the quarters is $(1.51).

For further illustration of the guidance on quarterly and year-to-date computations, refer to Example 1 from ASC 260 in Appendix E.

### 4.6.3 Mandatorily convertible instruments

Current practice for mandatorily convertible securities is to exclude the underlying shares from the calculation of basic EPS and include the dilutive effect of the instrument in diluted EPS using the if-converted method. If mandatorily convertible instruments meet the definition of a participating security, the two-class method should be applied in the calculation of basic EPS. In the calculation of diluted EPS, we believe the more dilutive of the two-class method or the if-converted method should be used. See section 5 for a discussion of participating securities and the two-class method.

## 4.7 Contingently convertible instruments

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

***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.

As noted in section 4.6, the effect of convertible instruments on diluted EPS generally is calculated using the if-converted method, which requires entities to add back certain adjustments required in ASC 260-10-45-40 (see section 4.6) to net income available to common shareholders and increase the weighted average shares outstanding for shares issuable upon conversion for the period the instrument was convertible. The effect on EPS of contingently convertible instruments is complicated by the fact that the instrument becomes convertible only if a specified event occurs, such as a change in control or achieving a specified stock price.

### 4.7.1 Contingency is not based on price of issuer's stock or the convertible instrument (updated September 2024)

We believe that if a convertible instrument is convertible only upon a contingency that is not based on the issuer's stock price or the price of the convertible instrument (a non-market-price contingency), the if-converted method generally should be applied only if the necessary conditions have been satisfied by the end of the period by using the number of shares, if any, that would be issuable using an assumption that the end of the reporting period was the end of the contingency period. This view is consistent with the guidance on contingently issuable shares as discussed in section 4.8. If the non-market-price contingency only accelerates the timing of a holder's ability to convert the instrument to common stock, the if-converted method generally should be applied in periods that the convertible security is outstanding. That is, the non-market-price contingency is disregarded in the diluted EPS calculation.

### 4.7.2 Contingency is based on the price of the issuer's stock or the convertible instrument (updated September 2024)

**FASB amendment**

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The ASU made a consequential amendment to ASC 260-10-45-44 (shown as pending content below) to delete the reference to "conventional" convertible instruments. As discussed in sections 4.1 and 4.6, ASU 2020-06 requires the use of the if-converted method to calculate diluted EPS for *all* convertible instruments. ASU 2020-06 also made minor consequential adjustments to Case A of Example 11 shown below (i.e., referred to new Case C of Example 11 (see section 4.9.1A) and updated a guidance reference in ASC 260-10-55-82). No assumptions or conclusions in Case A of Example 11 were changed.

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contingently Convertible Instruments*

*260-10-45-43*

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.

*260-10-45-44*

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

*260-10-45-44*

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.

ASC 260 addresses the accounting for contingently convertible instruments in which conversion into common stock is possible only if one or more specified contingencies occur (see discussion below regarding multiple contingencies), and at least one of these contingencies is based on the market price of the issuer's stock (a "market-price contingency"). The graphic below illustrates how the type of contingency affects the diluted EPS calculation:

| Type of contingency | Effect on diluted EPS |
|---|---|
| Market price | Include the dilutive effect of the instrument from the issuance date, even if the market-price contingency is not met |
| Non-market price* | Include the dilutive effect of the instrument only if the necessary conditions have been satisfied by the end of the period using an assumption that the end of the reporting period was the end of the contingency period (see section 4.7.1) |
| Either market price or non-market price | Include the dilutive effect of the instrument from the issuance date, even if the market-price or non-market-price contingency is not met |
| Both market price and non-market price* | Include the dilutive effect of the instrument from the date that all of the required non-market-price based contingencies are met using an assumption that the end of the reporting period was the end of the contingency period (i.e., ignore the market-priced contingency) (see section 4.8) |

* Refer to section 4.7.1 for considerations related to non-market-price contingencies that only accelerate the timing of a holder's ability to convert the instrument to common stock.

The guidance in ASC 260 is premised on the view that debt or preferred stock that is convertible into common stock upon the achievement of a specified price of the issuer's stock is not significantly different from other convertible debt in which the ability to convert is not contingent on the price of the issuer's shares because the holder would not convert the instrument if the conversion option is out-of-the-money. Additionally, the if-converted method ignores whether the conversion option in convertible debt is in-the-money or not. Accordingly, the computation of diluted EPS for contingently convertible instruments with a market-price contingency differs from that for a market-price contingency in contingently issuable shares or contingently issuable potential common shares (see Question 4-2 below). As a result, issuers should include the dilutive effect of the instrument in diluted EPS upon issuance (even if the instrument is not currently convertible), rather than waiting until the specified share price is met, if the achievement of a specified share price causes the instrument to become convertible (without regard to any other contingencies). That is, the market-price contingency is ignored for purposes of applying the if-converted method.

ASC 260's guidance does not apply directly to contingently convertible instruments if the contingency is not based on the market price of the issuer's stock. For example, some instruments may become convertible upon a change in control, an IPO or other event. Practice will therefore follow the guidance as described in section 4.7.1 for these instruments.

However, ASC 260-10-45-44 does consider how to calculate the dilutive effect of convertible instruments whose conversion is contingent on one or more specified criteria when at least one of those criteria is based on the issuer's share price as follows:

- If achievement of the market-price contingency alone (irrespective of whether the other contingencies are met) causes the instrument to become convertible (i.e., the conversion is not dependent, or no longer dependent, on a non-market-price contingency), the dilutive effect of the instrument should be included in diluted EPS from the issuance date.

- If achievement of at least one non-market-price contingency is required for the instrument to become convertible (i.e., the conversion is dependent on a non-market-price contingency), the dilutive effect of the instrument should be included in diluted EPS from the date that all of the required non-market-price based contingencies are met using an assumption that the end of the reporting period was the end of the contingency period (i.e., the market-price contingency is ignored), unless the non-market-price contingency only accelerates the timing of a holder's ability to convert the instrument to common stock (see section 4.7.1). This view is consistent with the guidance on contingently issuable shares as discussed in section 4.8.

The guidance in ASC 260-10-45-43 and 45-44 (illustrated in Example 11 from ASC 260 below) applies to any conversion option embedded in a debt or equity host for which exercise is contingent upon the achievement of a specified issuer stock price. Accordingly, ASC 260 applies to convertible preferred stock as well as convertible debt. Further, the method of settlement of the convertible instrument does not affect whether the security is subject to this guidance. For example, some convertible debt instruments provide that, upon conversion, the accreted principal must be (or can be) settled in cash while the excess conversion value must be (or can be) settled in stock. Those convertible instruments also are subject to the guidance in ASC 260 if the ability to convert is contingent upon the achievement of a specified common stock price. The EPS effect of these instruments is discussed further in section 4.9.1 (before adoption of ASU 2020-06) or section 4.9.1A (after adoption of ASU 2020-06), which includes Case B of Example 11.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Implementation Guidance and Illustrations***

***Example 11: Computation of Basic and Diluted EPS for Two Examples of Contingently Convertible Instruments [Selected excerpts]***

*260-10-55-78*

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).

**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 Three Examples of Contingently Convertible Instruments***

*260-10-55-78*

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).

*260-10-55-79*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-55-79*

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***

*260-10-55-81*

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.

*260-10-55-82*

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.)

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-55-82*

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.)

Question 4-2

**How should an entity evaluate a contingently convertible instrument with a market price trigger versus a contingently issuable share with a market price trigger when calculating diluted EPS?**

ASC 260 has specific guidance for contingently convertible instruments and contingently issuable shares. The guidance in ASC 260-10-45-44 explicitly states that contingently convertible instruments with a market price trigger should be included in diluted EPS (if dilutive), regardless of whether the market price trigger has been met or the instrument is currently convertible. However, contingently issuable shares (i.e., shares issuable for little or no cash consideration upon the satisfaction of certain conditions) with a market price trigger are only included in diluted EPS if the criteria in ASC 260-10-45-48 are met. Refer to section 4.8 for more information.

## 4.8 Contingently issuable shares (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

*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.**

*Other Presentation Matters*

*Diluted EPS and Other Topics*

*Contingently Issuable Shares*

*260-10-45-48*

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).

*260-10-45-49*

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.

*260-10-45-50*

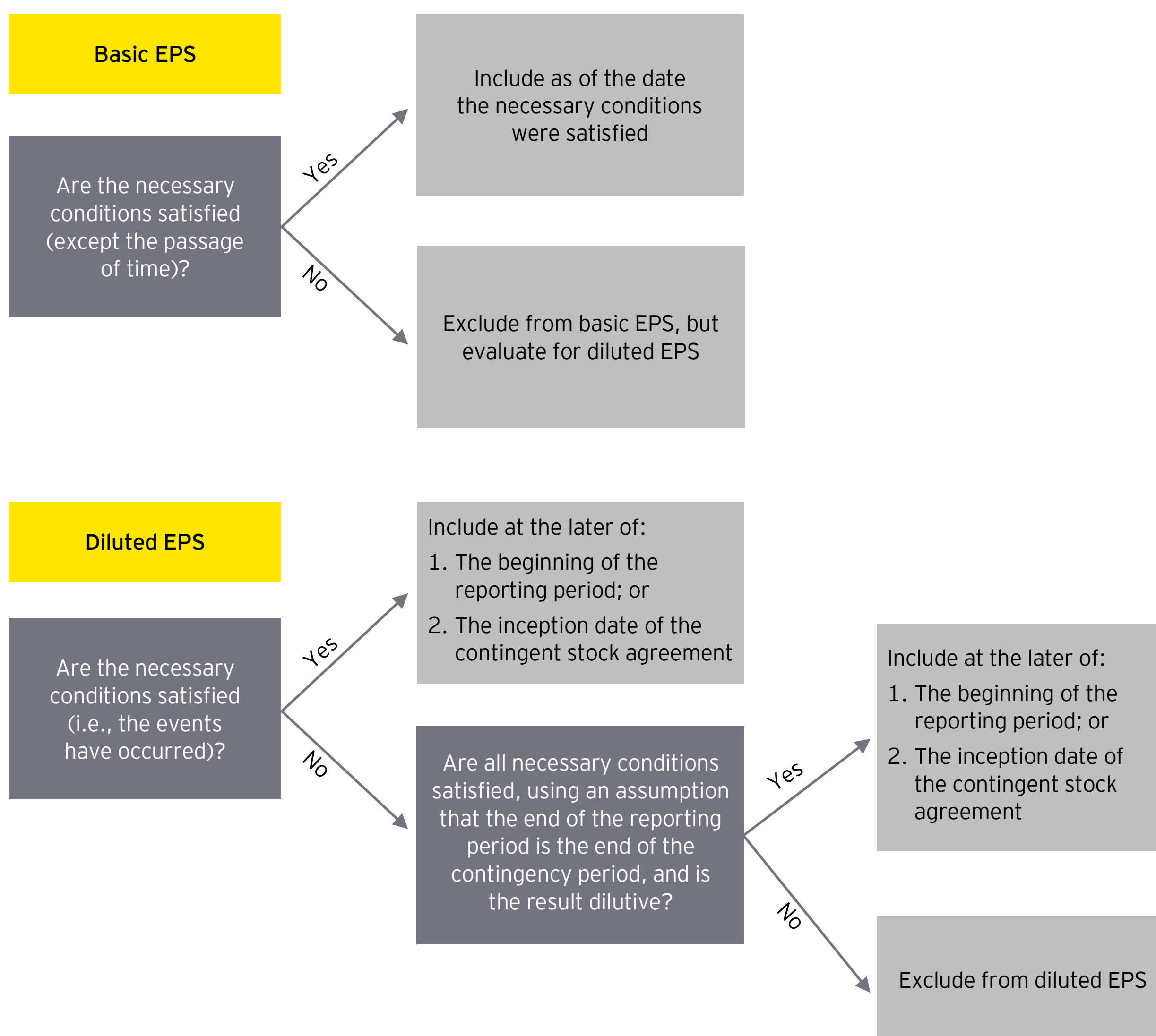
Paragraphs 260-10-45-51 through 45-54 provide general guidelines that shall be applied in determining the EPS impact of different types of contingencies that may be included in contingent stock agreements.

Contingently issuable shares are shares issuable for little or no cash consideration upon the satisfaction of certain conditions. Contingently issuable shares are included in the calculation of basic EPS as of the date that all necessary conditions have been satisfied (i.e., when issuance of the shares is no longer contingent on any conditions except the passage of time) (see section 3.3.2). Unlike the requirements for basic EPS, when all the necessary conditions have been satisfied by the end of the period (i.e., the events have occurred), those shares should be included in the denominator of the diluted EPS calculation as of the beginning of the period in which the conditions are satisfied or as of the inception date of the contingent stock arrangement, if later.

Prior to the end of the contingency period, the number of contingently issuable shares included in the denominator of the diluted EPS calculation performed at the end of the reporting period is based on the number of shares, if any, that would be issuable under the terms of the arrangement using an assumption that the end of the reporting period was the end of the contingency period, assuming the result would be dilutive. Those shares should be included in the denominator of the diluted EPS calculation as of the beginning of the period or as of the inception date of the contingent stock arrangement, if later.

As discussed in section 3.3.2 and ASC 260-10-45-13, outstanding common shares that are contingently returnable (i.e., subject to recall) are treated in the same manner as contingently issuable shares.

The flowchart below summarizes the guidance on contingently issuable shares for basic and diluted EPS:




Under ASC 260, situations may arise where contingently issuable shares are considered outstanding in one quarter and not outstanding the next quarter (e.g., a sales threshold is met in one quarter, but not met in subsequent quarters). EPS amounts for previous periods are not restated even when the resolution of the contingency is known. Because contingently issuable shares may be treated as outstanding in one period and not outstanding in a subsequent period, volatility in diluted EPS can result.

For year-to-date and annual EPS computations, contingently issuable shares should be included on a weighted average basis (e.g., assuming each of the quarters was profitable, contingently issuable shares should be weighted for the interim periods in which they were included in the computation of diluted EPS). That is, the shares are included based on the sum of the contingently issuable shares treated as outstanding for the quarters divided by four when computing annual diluted EPS.

In determining the weighted average of the contingently issuable shares included in interim periods for year-to-date and annual diluted EPS calculations, an added complication arises when losses are incurred during the quarters. If dilutive contingently issuable shares are excluded from a quarterly computation because a loss was incurred and the contingently issuable shares have an antidilutive effect for that quarter, such shares would still be included in year-to-date and annual periods provided those periods were profitable, and the effect of including the shares is dilutive. Thus, the treatment of contingently issuable

shares in year-to-date and annual computations is similar to the treasury stock method (see section 4.3.2). That is, both computations are based on the weighted average of the interim periods, but with special provisions when the interim periods include a loss period. Example 3 in ASC 260 (see section 4.8.5) shows quarterly and year-to-date diluted EPS calculations for contingently issuable shares.

As further discussed in section 4.4.2, share-based payments subject to performance or market conditions are considered contingently issuable shares for purposes of calculating diluted EPS. Thus, they are not included in the diluted EPS denominator until the performance or market criteria are met, assuming that the end of the reporting period is the end of the contingency period (see further discussion in section 4.8.1). However, share-based payments subject only to service-based vesting should be considered outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent on satisfying a service condition (see section 4.4.1.1).

### 4.8.1 Contingencies based on earnings levels or market price of stock

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contingently Issuable Shares*

*260-10-45-51*

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.

*260-10-45-52*

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.

*260-10-45-53*

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.

If attainment or maintenance of a specified level of earnings is the condition for issuance of additional shares of stock, and that amount of earnings is presently being attained, the contingently issuable shares should be considered outstanding as of the beginning of the period (or as of the inception date of the contingent stock arrangement, if later) for diluted EPS purposes if the effect is dilutive. The diluted EPS computation should include those shares that would be issued under the agreement based on the

assumption that the current amount of earnings will remain unchanged until the end of the agreement. The specified earnings level must be attained the end of the contingency period for the shares to be considered outstanding. At a reporting date, being ahead of schedule or on pace to achieve a specified earnings target by the end of a contingency period is not a sufficient basis for treating the contingently issuable shares as outstanding. Note that Example 3 (referred to in ASC 260-10-45-51 above) is included in section 4.8.5.

If the market price of the stock at a future date is the contingent condition, computations of diluted EPS should 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. The contingently issuable shares should be considered outstanding as of the beginning of the period (or as of the inception date of the contingent stock arrangement, if later). If the condition is based on an average of market prices over some period of time, the average for that period should be used assuming the period ends on the balance sheet date.

In some situations, the number of shares contingently issuable may depend on both future earnings and future market prices of the shares. If both conditions are met at the end of the reporting period, using an assumption that the end of the reporting period was the end of the contingency period, contingently issuable shares should be included in the diluted EPS calculation as of the beginning of the period (or as of the inception date of the contingent stock arrangement, if later). If one of the conditions is not met at the end of the reporting period, no contingently issuable shares would be included in the diluted EPS calculation.

However, if all or a portion of the shares are issuable if only one of the conditions is met, the shares associated with the condition(s) that would be met using an assumption that the end of the reporting period was the end of the contingency period would be included in the diluted EPS calculation as of the beginning of the period (or as of the inception date of the contingent stock arrangement, if later).

## 4.8.2 Contingencies involving multiple reporting periods

The contingently issuable share provisions of ASC 260 can be difficult to apply when a contingency is based on events that must occur in multiple reporting periods that include future periods. The following examples illustrate the application of this guidance:

**Illustration 4-10: Contingently issuable shares when multiple contingencies apply to multiple reporting periods**

Assume that under a business combination agreement, an additional 1 million shares will be issued to former stockholders of an acquired entity for **each year during the three-year period** after the business combination that annual earnings exceed $10 million (i.e., 3 million potential shares issuable). Earnings at the end of Year 1 are $11 million (assume that earnings exceeded the $10 million target as a result of fourth quarter operating results).

Based on discussions with the FASB staff, we believe this arrangement would be viewed as three separate contingencies (i.e., each year is a separate contingency). Each contingency period is evaluated separately to determine whether the contingency has been met, using an assumption that the end of the reporting period was the end of the contingency period. Therefore, because earnings are $11 million at the end of Year 1, 1 million shares would be added to the denominator for diluted EPS for Year 1, but no additional shares would be assumed as outstanding for the earnings contingencies in Years 2 and 3. That’s because the criteria for Years 2 and 3 have not been met.

We believe an acceptable alternative would be to evaluate the amount of earnings generated in the current period ($11 million in Year 1) as if it were the amount earned in each contingency period (i.e., assume that earnings will be the same in each future period), since each year is treated as a separate contingency. Under this alternative, the Year 1 earnings threshold of $10 million has been satisfied, and the annual earnings threshold of $10 million for Years 2 and 3 would also have been satisfied if the end of the reporting period was the end of those contingency periods. Therefore, under this approach, a total of 3 million shares (i.e., 1 million shares for each of the three years) would be added to the denominator for diluted EPS in Year 1 even though the shares for Years 2 and 3 will be issued only if the entity exceeds the earnings threshold in each of those years.

However, under this alternative, we believe ASC 260 should be interpreted so that the 3 million shares would be excluded from the denominator of the diluted EPS calculation for each quarter in Years 2 and 3 until earnings in each of those years exceed $10 million.[11] Thus, if the first-quarter earnings in Year 2 are $9 million (only $1 million short of the threshold), no shares related to the contingency would be considered outstanding for the first quarter. Assuming that Company A exceeds the threshold in the second quarter of Year 2, the shares are assumed to be outstanding as of the beginning of the second quarter of Year 2. However, the shares would be excluded from the denominator in Year 3 until the quarter in which earnings exceed the $10 million target threshold.

**Illustration 4-11: Contingently issuable shares when one contingency applies to multiple reporting periods**

Assume that under a business combination agreement, if Company A's operations generate earnings in excess of $10 million in **each of the next three consecutive years**, an additional 3 million shares will be issued to former stockholders of an acquired entity. Earnings at the end of Year 1 are $11 million (assume that earnings exceeded the $10 million target as a result of fourth quarter operating results).

Based on our discussions with the FASB staff, we believe that the earnings contingency would be viewed as a single contingency. Therefore, Company A would assume that the contingency will be met as if the last day of Year 1 was the end of the contingency period, and earnings over the next two years remain unchanged. Thus, it would be assumed that the 3 million shares would be issued at the beginning of the last quarter of Year 1.

However, we believe ASC 260 should be interpreted so that the shares would be excluded from the denominator for each quarter in Years 2 and 3 until earnings in each of those years exceed $10 million.[12] Thus, if the first-quarter earnings in Year 2 are $9 million (only $1 million short of the threshold), no shares related to the contingency would be considered outstanding for the first quarter. Assuming that Company A exceeds the threshold in the second quarter of Year 2, the shares are assumed to be outstanding as of the beginning of the second quarter of Year 2. However, the shares would be excluded from the denominator in Year 3 until the quarter in which earnings exceed the $10 million target threshold.

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[11] This treatment should be applied even though ASC 270 allows for the spreading of certain other amounts ratably over interim periods. ASC 260 precludes any assumption that the threshold subsequently will be met in computing quarterly EPS, regardless of whether it appears probable.

[12] This treatment should be applied even though ASC 270 allows for the spreading of certain other amounts ratably over interim periods. ASC 260 precludes any assumption that the threshold subsequently will be met in computing quarterly EPS, regardless of whether it appears probable.

We believe an acceptable alternative would be to evaluate the contingency as a single contingency with three inputs, based on attaining a certain level of earnings in each year. Under this alternative, Company A would not assume that earnings will remain unchanged for Year 2 and Year 3. Instead, Company A would evaluate each of the three inputs to determine whether the contingency has been met assuming the end of the reporting period was the end of the contingency period. Company A would conclude that the incremental 3 million shares would not be included in the denominator until after the $10 million threshold was achieved for Year 3, assuming the earnings in Year 1 and Year 2 exceeded the $10 million threshold. This is because "the condition" (i.e., earnings above a certain threshold each year for a three-year period) is achieved only when earnings exceed $10 million in each of the three consecutive years.

**Illustration 4-12: Contingently issuable shares when one contingency is based on an average over multiple reporting periods**

Assume that under a business combination agreement, if Company A's operations generate a **three-year average earnings growth** above 5%, an additional 5 million shares will be issued to former stockholders of an acquired entity. The earnings growth rate at the end of Year 1 is 6% (assume that the earnings growth rate exceeded the 6% target as a result of fourth-quarter operating results).

Similar to Illustration 4-11, we believe, in this situation, the three-year average earnings growth rate should be viewed as a single contingency. Company A would assume that the earnings growth rates over the next two years will remain unchanged. Since the average earnings growth rate of 6% exceeded the 5% target as of the end of the reporting period, Company A would assume that the 5 million shares would be issued at the beginning of the last quarter of Year 1.

Also similar to Illustration 4-11, we believe an acceptable alternative would be to evaluate the contingency as a single contingency with three inputs based on earnings growth in each year. Under this alternative, Company A would not assume that earnings growth would remain unchanged for Year 2 and Year 3. Instead, Company A would conclude that no shares would be issued at the beginning of the last quarter of Year 1 because the three-year average earnings growth rate is less than the 5% target (i.e., [6% + 0 + 0] ÷ 3 = 2%).

## 4.8.3 Other contingency provisions

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contingently Issuable Shares*

*260-10-45-54*

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.

If the contingency is based on a condition other than earnings or market price (e.g., contingencies based on opening a certain number of retail stores or contingencies based on the close of an acquisition), the contingently issuable shares should be included in the computation of diluted EPS based on the assumptions that (1) the current status of the condition will remain unchanged until the end of the contingency period and (2) the end of the reporting period is the end of the contingency period. Again, it is important to emphasize that the contingency must be attained by the end of the reporting period. Note that Example 3 (referred to in ASC 260-10-45-54 above) is included in section 4.8.5.

### 4.8.4 Contingently issuable potential common shares

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Other Presentation Matters***

***Diluted EPS and Related Topics***

***Contingently Issuable Shares***

***260-10-45-55***

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.

***260-10-45-56***

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.

***260-10-45-57***

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.

Contingently issuable potential common shares such as contingently issuable options should be included in the diluted EPS calculation based on the contingency provisions discussed above (e.g., contingencies related to earnings or market price). If the contingency provisions are met by the end of the reporting period, or the contingency provisions are met using an assumption that the end of the reporting period is the end of the contingency period, an entity should determine the effect on the computation of diluted EPS based on the provisions included in ASC 260 for options and warrants in ASC 260-10-45-22 through 45-32 (discussed in sections 4.3 and 4.4), the provisions for convertible securities in ASC 260-10-45-40 through 45-42 (discussed in section 4.6), and the provisions for contracts that may be settled in stock or cash in ASC 260-10-45-45 through 45-47 (discussed in section 4.9 (before the adoption of ASU 2020-06) and in section 4.9A (after the adoption of ASU 2020-06)), as appropriate. However, exercise or conversion should not be assumed for purposes of computing diluted EPS unless exercise or conversion of similar outstanding potential common shares, if any, that are not contingently issuable is also assumed. Note that Example 3 (referred to in ASC 260-10-45-57 above) is included in section 4.8.5.

## 4.8.5 Examples of the application of the contingently issuable shares guidance

The following example illustrates the consideration of contingently issuable shares in the computation of basic and diluted EPS:

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 3: Contingently Issuable Shares*

*260-10-55-53*

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.

*260-10-55-54*

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.

*260-10-55-55*

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

*260-10-55-56*

| | **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 x 2/3

(b) 1,000 shares + (1,000 shares x 1/3)

(c) (1,000 shares x 8/12) + (1,000 shares x 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] x 5 shares

(h) Year-to-date, after-tax net income was less than $500,000.

(i) [($700,000 − $500,000) ÷ $100] x 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.

The following example illustrates the effect of contingently issuable shares on the computation of basic and diluted EPS:

**Illustration 4-13: Effect of contingently issuable shares on basic and diluted EPS**

Company A (with a calendar year-end) acquired Company B on 1 January 20X2, and the consideration included contingently issuable shares of common stock of Company A. Under the arrangement, 1 million shares will be issued to the selling shareholders of Company B only if the earnings of Company B equal or exceed $12 million at the end of the year. Earnings of Company B are $16 million in 20X2 (assume equal amounts per quarter). The threshold is met, but the 1 million shares physically are not issued until March 20X3 to allow sufficient time to close the books and process the issuance of the shares.

***Basic EPS*** — Under ASC 260, additional shares are included in the denominator for basic EPS only for one day (31 December 20X2) because the shares do not become issuable under the agreement until 31 December 20X2 (that calculation is not presented herein). The shares are not included in the denominator for basic EPS at 30 September 20X2, when Company B has recognized $12 million to date in earnings for 20X2, because for basic EPS it cannot be assumed that the Company will not incur a loss in the fourth quarter of 20X2 (i.e., it is not certain that the shares will be issued). In the first quarter of 20X3, the shares will be treated as outstanding for EPS purposes as of 31 December 20X2, even though they physically were not issued until March 20X3.

***Diluted EPS*** — Because future earnings are not assumed and the contingent threshold has not been attained, no shares are included in the denominator for diluted EPS for any periods before the quarter ended 30 September 20X2.

At 30 September 20X2, Company B has recognized $12 million in earnings over the previous nine months. Under ASC 260, if the end of the reporting period (30 September 20X2) also was the end of the contingency period (31 December 20X2), Company B would have attained the specified level of earnings during the third quarter, assuming that earnings would not change. Therefore, the 1 million shares are included in the denominator for diluted EPS for the entire quarter ended 30 September 20X2, as if they had been issued on 1 July 20X2. The shares also would be assumed to be outstanding for the quarter ended 31 December 20X2.

When computing the diluted EPS for 20X2, 500,000 shares [(0 + 0 + 1,000,000 + 1,000,000) ÷ 4] would be included in the denominator for diluted EPS for the calendar year, and 333,333 shares [(0 + 0 + 1,000,000) ÷ 3] for the year-to-date period ended 30 September 20X2.

The following table summarizes how many shares would be included in the denominator for each quarter and year-to-date or annual period for diluted EPS:

| | **31/3/20X2** | **30/6/20X2** | **30/9/20X2** | **31/12/20X2** |
|---|---|---|---|---|
| Shares included for diluted EPS for: | | | | |
| The quarter ended | - | - | 1,000,000 | 1,000,000 |
| The year-to-date period ended | - | - | 333,333 | 500,000 |

## 4.9 Contracts that may be settled in stock or cash (before adoption of ASU 2020-06)

This section and related subsections address contracts that may be settled in stock or cash before the adoption of ASU 2020-06. For discussion on how such contracts are treated after the adoption of ASU 2020-06, see section 4.9A.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contracts that May Be Settled in Stock or Cash*

*260-10-45-45*

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.

*260-10-45-46*

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.

*260-10-45-47*

Paragraphs 260-10-55-32 through 55-36A provide additional guidance on contracts that may be settled in stock or cash.

*Implementation Guidance and Illustrations [Selected excerpts]*

*Contracts that May Be Settled in Stock or Cash*

*260-10-55-32*

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).

*260-10-55-34*

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.

*260-10-55-36*

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.

If an entity issues a contract that may be settled in common stock or cash, the determination of how that contract should be reflected in the computation of diluted EPS (e.g., whether additional shares should be added to the denominator) will depend on (1) which party controls the means of settlement and the facts available each period and (2) if there are differences in financial statement classification and the treatment for EPS purposes (e.g., an instrument that is classified as an asset or liability for accounting purposes but share settlement is presumed for EPS).

#### Means of settlement

***Means of settlement determined by the counterparty*** — For contracts settled in common stock or cash at the election of the counterparty, the issuer's stated policy or past experience for settling similar contracts (discussed further below) is not determinative. Therefore, the more dilutive of common stock or cash should be used in accordance with ASC 260-10-55-36.

Share-based compensation arrangements that are payable in common stock or in cash at the election of the grantee should be accounted for in the same fashion (i.e., the more dilutive of cash or share settlement should be used). For further discussion, refer to section 4.9.3.

***Means of settlement determined by the issuer*** — Contracts settled in common stock or cash at the election of the issuer should be assumed to be stock settled for EPS purposes. 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 settled in cash. If the issuer's intent or stated policy is to settle the contract in cash, we would expect the issuer to disclose this intent in the notes to the financial statements if the potential dilutive effect of the contract would be material. See section 4.9.1 for considerations related to a registrant's stated policy to settle contracts in cash.

#### Differences in financial statement classification and the treatment for EPS purposes

The presumption of stock or cash settlement for EPS purposes may affect the numerator of the EPS calculation. This will arise when, for example, the presumption for EPS purposes is stock settlement when the instrument is classified as an asset or a liability for accounting purposes, or when cash settlement is presumed for EPS purposes and the instrument is classified as equity for accounting purposes. However, as noted in ASC 260-10-55-32, adjustments to the numerator are only permitted for an instrument for which the effect on net income (i.e., the numerator of the EPS calculation) is different depending on whether the instrument is accounted for as an equity instrument or as an asset or liability (e.g., instruments within the scope of ASC 480 or ASC 815-40). Instruments accounted for under ASC 480 and ASC 815-40 include:

> ***Written put options and forward purchase contracts*** — ASC 480 requires certain types of contracts indexed to, or potentially settled in, an entity's stock to be classified as liabilities (e.g., written put options, forward purchase contracts), regardless of the form of settlement. In computing diluted EPS, the reverse treasury stock method generally should be used to account for the dilutive effect of written put options that are in-the-money during the reporting period and certain forward purchase contracts. Under that method (described in more detail in section 4.10), the incremental number of shares to include in the denominator of the diluted EPS calculation is computed as the difference between (1) the number of shares assumed issued at the beginning of the period at the average market price during the period to raise enough proceeds to satisfy the contract and (2) the number of shares received (i.e., bought back) from satisfying the contract.

***Purchased options*** — Purchased put or purchased call options (options held by the entity on its own stock) should not be reflected in the computation of diluted EPS because to do so would be antidilutive. For further discussion of purchased options, refer to section 4.11.

***Other contracts*** — For a contract other than a purchased option that is not classified as a liability pursuant to ASC 480, an entity should consider the guidance in ASC 815-40. Among other things, ASC 815-40 provides guidance for determining whether a freestanding equity-linked instrument (e.g., warrants, options, forwards) should be accounted for as equity or as an asset/liability. To qualify for equity classification, the instrument must (1) be indexed to the issuer's stock and (2) meet certain conditions necessary for equity classification. For example, in general, under ASC 815-40-25, contracts that require net cash settlement are assets or liabilities, and contracts that require settlement in shares are equity instruments. If the contract provides the entity with a choice of net cash settlement or settlement in shares (and settlement in shares is within the control of the entity), settlement in shares is assumed. On the other hand, if the contract provides the counterparty with a choice of net cash settlement or settlement in shares, net cash settlement is assumed. Unlike ASC 260, the application of ASC 815-40-25 does not consider past experience or a stated policy when determining the balance sheet classification of the contract. ASC 815-40-25 considers only settlement methods. This may result in certain contracts being classified as assets and liabilities under ASC 815-40 and treated as share-settled (equity) for the calculation of diluted EPS (or vice versa). See Appendix B of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, for discussion of ASC 815-40.

ASC 260-10-55-36A (excerpted below) provides a table to illustrate when numerator (and denominator) adjustments would be required for contracts that are settled in cash or stock.

Including an instrument in diluted EPS is required even in periods when the entity reports a net loss, if the effect of the numerator and denominator adjustments is dilutive (see further discussion in Question 4-1 in section 4.2). When a net loss is incurred in the period, companies should not assume that an instrument is antidilutive. See Illustration 4-14 below.

A numerator adjustment is not required in periods when options and warrants are out-of-the-money (zero shares are included in the denominator). This is because ASC 260-10-45-25 states that options and warrants will have a dilutive effect under the treasury stock method only when they are in-the-money.

As discussed above, ASC 260 requires an adjustment to the numerator for any changes in income or loss that would result if a contract classified as an asset or liability is presumed to be share-settled for EPS purposes, and the instrument would be classified as equity under GAAP if it were required to be share-settled. In that circumstance, the gain or loss on remeasuring the instrument during the period (adjusted for the income tax effect) would be reversed in the numerator (as if it had been classified as equity during the period), if the result is dilutive when combined with any denominator adjustments. ASC 260-10-45-46 notes that this treatment is similar to the treatment for convertible debt (i.e., interest is eliminated from the numerator) discussed in section 4.6.

Similarly, adjustments to the numerator in the diluted EPS computation should be made for a contract that is classified as equity in accordance with ASC 815-40 but is assumed to be cash-settled for EPS purposes, and the instrument would be classified as an asset or liability under GAAP if it were required to be cash-settled (e.g., when an entity has a stated policy or for which past experience provides a reasonable basis to believe that such contracts will be settled partially or wholly in cash). In that case, any gain or loss that would result from remeasuring the contract pursuant to ASC 815-40 if it were an asset or liability would be recognized as a numerator adjustment, if dilutive when combined with any denominator adjustments.

For year-to-date diluted EPS calculations, ASC 260-10-55-34 states that the numerator adjustment is equal to the earnings effect (e.g., the change in the fair value of the asset or liability recorded under ASC 815-40-35) for the year-to-date period and 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, if the combined effect of the numerator and denominator adjustment is dilutive.

A table summarizing the requirements for potential numerator (and denominator) adjustments in the diluted EPS calculation for differences in financial statement classification and the treatment for EPS purposes follows:

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contracts that May Be Settled in Stock or Cash*

*260-10-55-36A*

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.

***Equity-linked instruments with assumed share settlement for diluted EPS —*** We believe the guidance above for contracts that may be settled in stock or cash also is applied to securities when share settlement is required (i.e., cash settlement is not an alternative) if those securities are classified as liabilities for financial reporting purposes. For these contracts, we believe a numerator adjustment will be required to account for the securities as equity-classified for EPS purposes.

The following example illustrates the EPS effect of a warrant that is required to be settled in stock but is liability-classified:

**Illustration 4-14: Liability-classified warrants settled in stock**

Company X had a net loss of $2 million in the first quarter of 20X2. Company X had 4 million weighted average shares of common stock outstanding during the first quarter. Company X issued warrants to buy 300,000 shares of common stock at $20 per share on 2 January 20X2. Assume that the warrants are classified as a liability under ASC 815-40 and are not participating securities. Company X recorded a gain of $120,000, net of income tax, due to the decrease in the fair value of the warrants during the first quarter. The average market price of the common stock for the quarter was $30.

The following illustrates the basic and diluted EPS calculations for the first quarter of 20X2:

| | First Quarter |
|---|---|
| **Basic EPS computation** | |
| Income (loss) available to common stockholders | $ (2,000,000) |
| Weighted average shares outstanding | 4,000,000 |

The equation for computing basic EPS is:

$$\frac{\text{Income (loss) available to common stockholders}}{\text{Weighted average shares}}$$

**Basic EPS $(0.50)**

| | |
|---|---|
| **Diluted EPS computation** | |
| Net income (loss) | $ (2,000,000) |
| Less: decrease in fair value of warrants, net of income tax | (120,000) |
| Income (loss) available to common stockholders | $ (2,120,000) |
| Weighted average shares | 4,000,000 |
| Plus: incremental shares from assumed exercise | 100,000 (a) |
| Adjusted weighted average shares | 4,100,000 |

The equation for computing dilutive EPS is:

$$\frac{\text{Income (loss) available to common stockholders (assumes settlement of warrant in shares)}}{\text{Adjusted weighted average shares}}$$

**Diluted EPS $(0.52) (rounded)**

(a) The effect of the outstanding warrants is reflected in diluted EPS by applying ASC 260-10-55-34. The assumed proceeds of $6 million (300,000 warrants x $20 exercise price) from the assumed exercise of the warrants would acquire 200,000 ($6,000,000 / $30 average market price) shares of common stock in the market. Therefore, the 100,000 (300,000 − 200,000) incremental shares assumed to be issued would be added to the denominator in the diluted EPS calculation for the period.

### 4.9.1 Convertible debt with issuer option to settle for cash upon conversion (before adoption of ASU 2020-06)

Some convertible debt instruments are convertible into a notionally fixed number of common shares where the issuer is required or has the option to satisfy all or part of the obligation in cash. EITF 90-19 addressed the effect of three convertible debt instruments (Instruments A, B and C) on EPS. FSP APB 14-1 (primarily codified in ASC 470-20) superseded EITF 90-19 upon its effective date (i.e., fiscal years beginning after 15 December 2008). However, the EPS conclusions reached in EITF 90-19 effectively remain unchanged. We also believe that entities can apply the guidance below to convertible preferred stock instruments where the issuer is also required or has the option to satisfy all or part of the obligation in cash.

Instrument A is convertible debt that must be settled for cash upon conversion. It does not affect diluted EPS since the security must be settled in cash and therefore does not meet the definition of potential common stock. ASC 260 implicitly supports the consensus reached for Instrument A.

Instrument B provides that, upon conversion, the issuer may satisfy the entire obligation in either stock or cash in an amount equal to the conversion value. Instrument B is accounted for as conventional convertible debt. Therefore, this instrument generally would be included in diluted EPS using the if-converted method (see section 4.6) unless past experience or a stated policy provides a reasonable basis to believe that the issuer would settle the instrument in cash.

Instrument C is a convertible debt instrument that (a) requires the accreted value of the debt instrument to be settled in cash and (b) permits the excess conversion premium to be settled in stock or cash. Under ASC 260, the dilutive effect of Instrument C is limited to the conversion premium, which is reflected in the calculation of diluted EPS as if it were a freestanding written call option on the issuer's shares. Therefore, the effect of the conversion spread would be included in diluted EPS based on ASC 260's provisions for contracts that may be settled in stock or cash, which require that unless past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash, the potential dilutive effect of the call must be considered in the calculation of diluted EPS using the treasury stock method. The conclusion reached for Instrument C is illustrated in Case B of Example 11 from ASC 260 (see below).

The example shows the number of shares being included in the denominator based on the average market price of the shares during the reporting period. However, we understand that the method used in this example was not intended to illustrate the only acceptable method to calculate the dilutive effect of the instrument. As discussed in section 4.6.1, we also believe it would be acceptable to calculate the number of shares to be included in the denominator based on the market price at the end of the period, based on an analogy to the contingently issuable shares guidance in ASC 260-10-45-52. Entities should select an accounting policy in this regard and apply that policy consistently to all similar instruments.

In a speech at the American Institute of Certified Public Accountants (AICPA) National Conference on Current SEC Developments in 2003,[13] an SEC staff member described Instrument X, which is a convertible debt instrument that provides the issuer with the ability to settle the principal and interest as well as the conversion premium in any combination of stock or cash. For EPS purposes, the presumption that the contract will be settled in common stock may be overcome if the entity controls the means of settlement and past experience or a stated policy provides a reasonable basis to believe that the contract will be partially or wholly settled in cash. If a company has the intention and a stated policy to settle only the principal in cash, the EPS effect would be consistent with that of Instrument C as described above.

In the speech, the SEC staff member also indicated that a registrant's stated policy must have substance if it is to be relied upon as the basis for excluding share settleable obligations from a registrant's diluted EPS calculation. The SEC staff member provided the following factors to consider in evaluating whether a "stated policy" has substance:

- Settlement alternatives as a selling point — Registrants and auditors should examine the extent to which the flexibility associated with the ability to share settle factored into senior management's decision to approve the issuance of the instrument rather than an instrument that only allowed for cash settlement.
- Intent and ability — Registrants and auditors should consider the extent to which the registrant has the positive intent and ability to cash settle the face value and interest components of the instrument upon conversion. Both current and projected liquidity should be considered in determining whether positive intent and ability exists. The registrant's independent auditors should also ask for a management representation attesting to the registrant's positive intent and ability to cash settle.
- Disclosure commensurate with intent — Auditors should consider the extent to which the disclosures included in a registrant's current period financial statements as well as those included in the instrument's offering documents acknowledge and support the registrant's positive intent and ability to adhere to its "stated policy."
- Past practice — Registrants and auditors should also examine whether the registrant has previously share settled contracts that provided a choice of settlement alternatives.

[13] Speech by Robert J. Comerford, 11 December 2003.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 11: Computation of Basic and Diluted EPS for Two Examples of Contingently Convertible Instruments [Selected excerpts]*

*260-10-55-78*

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).

*260-10-55-79*

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 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*

*260-10-55-84*

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.

*260-10-55-84A*

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.

*260-10-55-84B*

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.

## 4.9.2 Puts and calls on convertible debt that can be settled in stock or cash (before adoption of ASU 2020-06)

Some convertible debt instruments include contractual provisions that allow the holder to require the issuer to repurchase the convertible debt for a stated price (embedded put options). Additionally, some convertible debt instruments give the issuer the right to repurchase the convertible debt for a specified price (embedded call options). Such puts and calls must be analyzed under ASC 815 to determine whether they are derivatives that must be bifurcated from the host instrument. See our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, for assistance in making this determination.

If a convertible debt instrument includes puts or calls that provide the issuer the choice of settlement in shares of common stock (with a value on the settlement date equal to the put or call price) or cash, it is within the scope of the guidance in ASC 260 addressing contracts that may be settled in stock or cash.

As a result, unless the entity has a stated policy or past experience provides a reasonable basis to believe that such contracts will be paid partially or wholly in cash, the potential dilutive effect of the instrument must be considered in the calculation of diluted EPS (generally using the if-converted method). Generally, if the issuer's intent or stated policy is to settle the put or call in cash, we would expect the issuer to disclose this intent in the notes to the financial statements if the potential dilutive effect of the put or call would be material.

If the presumption that the contract will be settled in shares is not overcome, the application of the if-converted method in the calculation of EPS is complex. The complexity arises because the conversion price and resulting number of shares received upon exercise of the put or call normally is dependent on the current stock price at the time of settlement. Therefore, the number of shares to be delivered upon exercise of the put or call will differ from the number of shares to be delivered if the investor elects to convert.

A similar issue arises in connection with the accounting for convertible preferred stock held in an ESOP. Based on the guidance in ASC 718-40-45-6 through 45-8 (see section 4.5.1), we believe that if share settlement of instruments that contain puts or calls is presumed under ASC 260, entities should use the more dilutive of the effect of (1) the stated conversion rate or (2) the satisfaction of the put or call in shares. Shares issuable to satisfy the put or call should be computed using the price the instrument could be put or called at, divided by the average fair value of the common stock during the reporting period.

## 4.9.3 Share-based payment awards that may be settled in stock or cash (before adoption of ASU 2020-06)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Share-Based Payment Arrangements*

*260-10-45-30*

If share-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 share-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.

*Implementation Guidance and Illustrations*

*Contracts That May Be Settled in Stock or Cash*

*260-10-55-33*

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.

Certain share-based payments may be settled either in stock or cash at the election of either the company or the grantee. An example of such an award is a stock appreciation right (i.e., an award entitling an employee to receive cash, stock or a combination of cash and stock in an amount equivalent to any excess of the fair value of a stated number of shares of the employer's stock over a stated price) payable in stock or cash at the company’s election.

Similar to the computation of diluted EPS for other contracts that may be settled in stock or cash (as discussed in section 4.9), the computation of diluted EPS for these types of share-based payments must consider such awards based on the facts and circumstances each period. However, ASC 260-10-45-30 above references ASC 260-10-45-45 (see section 4.9), under which it is presumed that the award will be settled in stock and the resulting potential common shares included in diluted EPS, if the effect is more dilutive. This presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the award will be settled partly or wholly in cash. Of course, if that presumption were overcome, the substantive terms of the plan would be assumed to require cash settlement under ASC 718 and, as a result, the award would be accounted for as a liability as described in section 5 of our FRD, ***Share-based payment***. For a liability-classified award in which share settlement is assumed, the numerator in the diluted EPS computation should not be adjusted for any changes in income or loss resulting from the liability-classified award during the period as discussed in ASC 260-10-55-33.

## 4.9A Contracts that may be settled in stock or cash (after adoption of ASU 2020-06) (updated September 2024)

This section and related subsections address contracts that may be settled in stock or cash after the adoption of ASU 2020-06. For discussion on how such contracts are treated before the adoption of ASU 2020-06, see section 4.9.

**FASB amendment**

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. For instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, entities are required to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement, or whether the entity has a history or policy of cash settlement.

Under legacy GAAP (as discussed in section 4.9), how a contract that can be settled in cash or shares should be reflected in the computation of diluted EPS depends on which party controls the means of settlement and the facts available each period. This determination can result in incremental shares being included in the denominator, as well as adjustments to the numerator of the diluted EPS calculation. Numerator adjustments arise when, for example, the presumption for EPS purposes is stock settlement, but the instrument is classified as an asset or liability for accounting purposes. Similar adjustments may continue to be required after the adoption of the ASU, depending on how the instrument is classified for accounting purposes (e.g., if it is classified as a liability).

The ASU also amended ASC 260-10-55-34 to conform the calculation of the denominator in the year-to-date diluted EPS calculation when an entity must adjust the numerator to remove the earnings effect of contracts that are asset- or liability-classified but are presumed to be share-settled for EPS purposes to be consistent with the year-to-date calculation under the treasury stock method.

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contracts that May Be Settled in Stock or Cash*

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-45-45*

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.

*260-10-45-45A*

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.

*260-10-45-46*

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).

*260-10-45-47*

Paragraphs 260-10-55-32 through 55-36A provide additional guidance on contracts that may be settled in stock or cash.

*Implementation Guidance and Illustrations [Selected excerpts]*

*Contracts that May Be Settled in Stock or Cash*

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*260-10-55-32*

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. 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).

***260-10-55-34***

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.

***260-10-55-36***

Paragraph superseded by Accounting Standards Update No. 2020-06.

After the adoption of ASU 2020-06, for instruments that may be settled in cash or shares (e.g., a written call option that gives the holder a choice of settling in cash or common stock) and aren't liability-classified share-based payment awards, entities are required (under ASC 260-10-45-45) to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement, or whether the entity has a history or policy of cash settlement. We believe this guidance also applies to instruments that may be settled in cash or potential shares (e.g., a warrant on a convertible security that may be settled in cash or by delivering the convertible security). See section 4.9.3A for the treatment of liability-classified share-based payment awards that may be settled in stock or cash.

As discussed in the Basis for Conclusions of ASU 2020-06,[14] the Board decided to simplify the diluted EPS guidance for instruments that may be settled in cash or shares by removing an entity's ability to rebut the presumption about share settlement that is present in legacy GAAP (see section 4.9). The Board had concerns about an entity being able to classify an instrument in equity because it contractually may settle in shares but then exclude the shares from diluted EPS because of an assertion that the instrument would be cash settled. Further, the Board concluded that this revised guidance is more consistent with the principle of diluted EPS, which is a measure calculated on the assumption that all potentially dilutive securities are exercised.

However, as noted in ASC 260-10-45-45, if share settlement is contingent upon the occurrence of a specified event (other than an entity's own share price), the guidance on contingently issuable shares (see section 4.8) should be applied first. If the contingency would be considered met under that guidance, then the guidance in ASC 260-10-45-45 would be applied. In addition, if cash settlement of an instrument is only required upon liquidation, an entity should include the effect of share settlement in the diluted EPS calculation until the liquidation occurs.

## How we see it

After the adoption of ASU 2020-06, maximum potential dilution will be reflected in diluted EPS. Entities may report lower diluted EPS than they would under the legacy guidance, and the effect on EPS may not reflect an entity's expectations before settlement (i.e., if the entity intends to settle the instrument in cash).

[14] Paragraph BC113 of ASU 2020-06.

### Differences in financial statement classification and the treatment for EPS purposes

When computing diluted EPS, the accounting classification of a contract should be consistent with its assumed settlement. Accordingly, ASC 260-10-45-46 notes that an instrument classified as an asset or liability for accounting purposes may require an adjustment to the numerator of the diluted EPS calculation for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes (i.e., the contract is assumed to be settled in shares for EPS purposes). However, as noted in ASC 260-10-55-32, these adjustments to the numerator are only permitted for instruments for which the effect on net income (i.e., the numerator of the EPS calculation) is different depending on whether the instrument is accounted for as an equity instrument or as an asset or liability (e.g., instruments within the scope of ASC 480 or ASC 815-40). Instruments accounted for under ASC 480 and ASC 815-40 include:

***Written put options and forward purchase contracts*** — ASC 480 requires certain types of contracts indexed to, or potentially settled in, an entity's stock to be classified as liabilities (e.g., written put options, forward purchase contracts), regardless of the form of settlement. In computing diluted EPS, the reverse treasury stock method generally should be used to account for the dilutive effect of written put options that are in-the-money during the reporting period and certain forward purchase contracts . Under that method (described in more detail in section 4.10), the incremental number of shares to include in the denominator of the diluted EPS calculation is computed as the difference between (1) the number of shares assumed issued at the beginning of the period at the average market price during the period to raise enough proceeds to satisfy the contract and (2) the number of shares received (i.e., bought back) from satisfying the contract.

***Purchased options*** — Purchased put or purchased call options (options held by the entity on its own stock) should not be reflected in the computation of diluted EPS because to do so would be antidilutive. For further discussion of purchased options, refer to section 4.11.

***Other contracts*** — For a contract other than a purchased option that is not classified as a liability pursuant to ASC 480, an entity should consider the guidance in ASC 815-40. Among other things, ASC 815-40 provides guidance for determining whether a freestanding equity-linked instrument (e.g., warrants, options, forwards) should be accounted for as equity or as an asset/liability. To qualify for equity classification, the instrument must (1) be indexed to the issuer's stock and (2) meet certain conditions necessary for equity classification. Note that ASC 815-40 was amended by ASU 2020-06 to simplify pieces of the assessment that an issuer performs to determine whether a contract in their own equity qualifies for equity classification. As a result, more freestanding contracts will qualify for equity classification. See Appendix B of our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for discussion of ASC 815-40.

ASC 260-10-55-36A (excerpted below) provides a table to illustrate when numerator (and denominator) adjustments would be required for contracts that are settled in cash or stock.

Including an instrument in diluted EPS is required even in periods when the entity reports a net loss, if the effect of the numerator and denominator adjustments is dilutive (see further discussion in Question 4-1 in section 4.2). When a net loss is incurred in the period, companies should not assume that an instrument is antidilutive. See Illustration 4-15 below.

A numerator adjustment is not required in periods when options and warrants are out-of-the-money (zero shares are included in the denominator). This is because ASC 260-10-45-25 states that options and warrants will have a dilutive effect under the treasury stock method only when they are in-the-money.

As discussed above, ASC 260 requires an adjustment to the numerator for any changes in income or loss that would result if a contract classified as an asset or liability is presumed to be share-settled for EPS purposes, and the instrument would be classified as equity under GAAP if it were required to be share-settled. In that circumstance, the gain or loss on remeasuring the instrument during the period (adjusted for the income tax effect) would be reversed in the numerator (as if it had been classified as equity during

the period), if the result is dilutive when combined with any denominator adjustments. ASC 260-10-45-46 notes that this treatment is similar to the treatment for convertible debt (e.g., interest is eliminated from the numerator) discussed in section 4.6.

For year-to-date diluted EPS calculations, ASC 260-10-55-34 states that the numerator adjustment is equal to the earnings effect (e.g., the change in the fair value of the asset or liability recorded under ASC 815-40-35) for the year-to-date period, and the number of incremental shares included in the denominator should be determined in accordance with the guidance in ASC 260-10-55-3 (see section 4.3.2). This guidance requires that, when each period is profitable, the number of incremental shares included in the denominator is the weighted average of the incremental shares that were included in each of the quarterly diluted EPS calculations. This means that a year-to-date approach is used for the numerator, and an averaging approach is used for the denominator, if the result is dilutive when combined with any denominator adjustments.

Before the adoption of ASU 2020-06, the number of incremental shares included in the denominator was 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. As discussed in the Basis for Conclusions of ASU 2020-06,[15] this technical correction was made to ASC 260-10-55-34 to address the inconsistency between ASC 260-10-55-3 and ASC 260-10-55-34.

A table summarizing the requirements for potential numerator (and denominator) adjustments in the diluted EPS calculation for differences in financial statement classification and the treatment for EPS follows:

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Contracts That May be Settled in Stock of Cash*

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*260-10-55-36A*

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.

[15] Paragraph BC116 of ASU 2020-06.

***Equity-linked instruments with assumed share settlement for diluted EPS*** — We believe the guidance above for contracts that may be settled in stock or cash also is applied to securities when share settlement is required (i.e., cash settlement is not an alternative) if those securities are classified as liabilities for financial reporting purposes. For these contracts, we believe a numerator adjustment will be required to account for the securities as equity-classified for EPS purposes.

The following example illustrates the EPS effect of a warrant that is required to be settled in stock but is liability-classified:

**Illustration 4-15: Liability-classified warrants settled in stock**

Company X had a net loss of $2 million in the first quarter of 20X2. Company X had 4 million weighted average shares of common stock outstanding during the first quarter. Company X issued warrants to buy 300,000 shares of common stock at $20 per share on 2 January 20X2. Assume that the warrants are classified as a liability under ASC 815-40 and are not participating securities. Company X recorded a gain of $120,000, net of income tax, due to the decrease in the fair value of the warrants during the first quarter. The average market price of the common stock for the quarter was $30.

The following illustrates the basic and diluted EPS calculations for the first quarter of 20X2:

| | **First Quarter** |
|---|---|
| **Basic EPS computation** | |
| Income (loss) available to common stockholders | $ (2,000,000) |
| Weighted average shares outstanding | 4,000,000 |

The equation for computing basic EPS is:

Income (loss) available to common stockholders
÷
Weighted average shares

**Basic EPS $(0.50)**

| | |
|---|---|
| **Diluted EPS computation** | |
| Net income (loss) | $ (2,000,000) |
| Less: decrease in fair value of warrants, net of income tax | (120,000) |
| Income (loss) available to common stockholders | $ (2,120,000) |
| Weighted average shares | 4,000,000 |
| Plus: incremental shares from assumed exercise | 100,000 (a) |
| Adjusted weighted average shares | 4,100,000 |

The equation for computing dilutive EPS is:

Income (loss) available to common stockholders (assumes settlement of warrant in shares)
÷
Adjusted weighted average shares

**Diluted EPS $(0.52) (rounded)**

(a) The effect of the outstanding warrants is reflected in diluted EPS by applying ASC 260-10-55-34 (which refers to ASC 260-10-55-3). The assumed proceeds of $6 million (300,000 warrants x $20 exercise price) from the assumed exercise of the warrants would acquire 200,000 ($6,000,000 / $30 average market price) shares of common stock in the market. Therefore, the 100,000 (300,000 — 200,000) incremental shares assumed to be issued would be added to the denominator in the diluted EPS calculation for the period.

## 4.9.1A Convertible debt with issuer option to settle for cash upon conversion (after adoption of ASU 2020-06)

Some convertible debt instruments are convertible into a notionally fixed number of common shares where the issuer is required or has the option to satisfy all or part of the obligation in cash. EITF 90-19 addressed the effect of three convertible debt instruments (Instruments A, B and C) on EPS. FSP APB 14-1 (primarily codified in ASC 470-20) superseded EITF 90-19 upon its effective date (i.e., fiscal years beginning after 15 December 2008). However, the EPS conclusions reached in EITF 90-19 effectively remain unchanged until the adoption of ASU 2020-06. We also believe that entities can apply the guidance below to convertible preferred stock instruments where the issuer is also required or has the option to satisfy all or part of the obligation in cash.

Instrument A is convertible debt that must be settled for cash upon conversion. It does not affect diluted EPS since the security must be settled in cash and therefore does not meet the definition of potential common stock. ASC 260 implicitly supports the consensus reached for Instrument A.

Instrument B provides that, upon conversion, the issuer may satisfy the entire obligation in either stock or cash in an amount equal to the conversion value. Instrument B is accounted for as conventional convertible debt. Therefore, the presumed share settlement of this instrument would be included in diluted EPS using the if-converted method (see section 4.6), unless cash settlement is more dilutive.

Instrument C is a convertible debt instrument that (a) requires the accreted value of the debt instrument to be settled in cash and (b) permits the excess conversion premium to be settled in stock or cash. Under ASC 260, the dilutive effect of Instrument C is limited to the conversion premium, which is reflected in the calculation of diluted EPS as if it were a freestanding written call option on the issuer's shares. Therefore, after the adoption of ASU 2020-06, the effect of the presumed share settlement of the conversion spread would be included in diluted EPS based on ASC 260's provisions for contracts that may be settled in stock or cash, which require that the potential dilutive effect of the call must be considered in the calculation of diluted EPS using the if-converted method. Accordingly, as discussed in section 4.6, interest expense on convertible debt for which the principal is required to be paid in cash should not be added back to the numerator in accordance with ASC 260-10-45-40(b)(1). The conclusion reached for Instrument C is illustrated in Case B of Example 11 from ASC 260 (see below).

In a speech at the AICPA National Conference on Current SEC Developments in 2003,[16] an SEC staff member described Instrument X, which is a convertible debt instrument that provides the issuer with the ability to settle the principal and interest as well as the conversion premium in any combination of stock or cash. For EPS purposes, after the adoption of ASU 2020-06, the effect of the presumed stock settlement is required to be included in the calculation of diluted EPS using the if-converted method. The conclusion reached for Instrument X is illustrated in Case C of Example 11 from ASC 260 (see below).

### How we see it

After the adoption of ASU 2020-06, the EPS effects for Instruments B, C and X will change. That is because, before adoption of ASU 2020-06 and as discussed in section 4.9.1, an entity could assume cash settlement of all or a portion of the instrument, depending on its contractual terms, if it had past experience or a stated policy that provided a reasonable basis to believe that it would settle all or a portion of the instrument in cash. ASU 2020-06 eliminated the ability to rebut a share settlement presumption for all convertible instruments.

[16] Speech by Robert J. Comerford, 11 December 2003.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

***Example 11: Computation of Basic and Diluted EPS for Three Examples of Contingently Convertible Instruments [Selected excerpts]***

### Pending Content:

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*260-10-55-78*

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).

*260-10-55-79*

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 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***

*260-10-55-84*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-55-84A*

The if-converted method should 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.

*260-10-55-84B*

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***

*260-10-55-84C*

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.

*260-10-55-84D*

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.

*260-10-55-84E*

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.

## 4.9.2A Puts and calls on convertible debt that can be settled in stock or cash (after adoption of ASU 2020-06)

Some convertible debt instruments include contractual provisions that allow the holder to require the issuer to repurchase the convertible debt for a stated price (embedded put options). Additionally, some convertible debt instruments give the issuer the right to repurchase the convertible debt for a specified price (embedded call options). Such puts and calls must be analyzed under ASC 815 to determine whether they are derivatives that must be bifurcated from the host instrument.

If a convertible debt instrument includes puts or calls that provide either party the choice of settlement in shares of common stock (with a value on the settlement date equal to the put or call price) or cash, it is within the scope of the guidance in ASC 260 addressing contracts that may be settled in stock or cash.

As a result of the adoption of ASU 2020-06, the potential dilutive effect of the instrument must be considered in the calculation of diluted EPS using the if-converted method (see section 4.6). The application of the if-converted method may be complex in these instances because the conversion price and resulting number of shares received upon exercise of the put or call normally is dependent on the current stock price at the time of settlement. Therefore, the number of shares to be delivered upon exercise of the put or call will differ from the number of shares to be delivered if the investor elects to convert. As discussed in section 4.6.1A, if the number of incremental shares upon exercise is variable, an entity would apply the guidance in ASC 260-10-45-21A and use the average share price to calculate the number of shares included in the denominator for both the treasury stock method and the if-converted method.

A similar issue arises in connection with the accounting for convertible preferred stock held in an ESOP. Based on the guidance in ASC 718-40-45-6 through 45-8 (see section 4.5.1), we believe that share settlement of instruments that contain puts or calls is required under ASC 260, and entities should use the more dilutive of the effect of (1) the stated conversion rate or (2) the satisfaction of the put or call in shares. Shares issuable to satisfy the put or call should be computed using the price the instrument could be put or called at, divided by the average fair value of the common stock during the reporting period.

## 4.9.3A Share-based payment awards that may be settled in stock or cash (after adoption of ASU 2020-06)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Diluted EPS and Related Topics*

*Share-Based Payment Arrangements*

*260-10-45-30*

If share-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 share-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.

*Contracts That May Be Settled in Stock or Cash*

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-45-45*

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.

*260-10-45-45A*

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.

*Implementation Guidance and Illustrations*

*Contracts That May Be Settled in Stock or Cash*

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* | **Transition Guidance:** 815-40-65-1

*260-10-55-33*

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.

Certain share-based payments may be settled either in stock or cash at the election of either the company or the grantee. An example of such an award is a stock appreciation right (i.e., an award entitling an employee to receive cash, stock or a combination of cash and stock in an amount equivalent to any excess of the fair value of a stated number of shares of the employer's stock over a stated price) payable in stock or cash at either the company's or the grantee's election. The computation of diluted EPS for these types of share-based payments will be similar to that discussed in section 4.9A, unless the share-based payment arrangement is classified as a liability under ASC 718-10-25-15.

That is, in accordance with ASC 260-10-45-45, for share-based payment awards that may be settled either in stock or cash and *are not* liability-classified, an entity is required to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement, or whether the entity has a history or policy of cash settlement.

For share-based payment awards that may be settled either in stock or cash (at the election of either entity or the holder) and *are* liability-classified under ASC 718-10-25-15 (see section 5 of our FRD, ***Share-based payment***), an entity must consider such awards based on the facts and circumstances each period. However, it is presumed that the award will be settled in stock and the resulting potential common shares included in diluted EPS, if the effect is more dilutive. This presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the award will be settled partly or wholly in cash. For a liability-classified award in which share settlement is assumed, the numerator in the diluted EPS computation should not be adjusted for any changes in income or loss resulting from the liability-classified award during the period as discussed in ASC 260-10-55-33.

As noted in the Basis for Conclusions of ASU 2020-06,[17] the Board decided to retain the legacy guidance for liability-classified share-based payment awards because the classification guidance in ASC 718 is different from that in ASC 815-40 (that was amended by ASU 2020-06) and was outside the scope of the project.

However, a shared-based payment award that must be settled in cash (e.g., a stock appreciation right where share settlement is not an option) is not included in the calculation of basic or diluted EPS. That is, a share-based payment award that always must be settled in cash is not included in the denominator in the EPS calculation, but the compensation cost recorded in net income under ASC 718 (and therefore income available to common stockholders) will affect the numerator in the EPS calculation.

## 4.10 Written put options, certain forward purchase contracts and the reverse treasury stock method (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Written Put Options and the Reverse Treasury Stock Method*

*260-10-45-35*

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.

[17] Paragraph BC114 of ASU 2020-06.

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.

*260-10-45-36*

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.

The reverse treasury stock method should be used to calculate the dilutive effect of written put options and certain forward purchase contracts (i.e., forward purchase contracts that are not accounted for under ASC 480-10-30-3 through 30-5 and ASC 480-10-35-3). A written put option is an option contract that *could* obligate an issuer to purchase its own shares from a counterparty, at the counterparty's choice, at a predetermined price at a future date. A forward purchase contract is a contract that *requires* the issuer to purchase its own shares from a counterparty at a predetermined price at a future date. If the average market price is lower than the exercise price of those contracts (i.e., they are in-the-money), the written put option or forward purchase contract would generally be dilutive. Under the reverse treasury stock method, if the instrument is dilutive, the incremental number of shares to include in the denominator of the diluted EPS calculation is computed as the difference between (1) the number of shares assumed issued at the beginning of the period at the average market price during the period to raise enough proceeds to satisfy the contract and (2) the number of shares received (i.e., bought back) from satisfying the contract.

In addition, we believe certain forward purchase contracts could be dilutive even if they are out-of-the-money. If a forward purchase contract must be settled through the issuance of shares regardless of whether it is in-the-money or out-of-the-money from the counterparty's perspective, we believe the reverse treasury stock method should be applied to determine whether it results in dilution (after also considering any numerator adjustments). That is, an entity should not assume such a forward purchase contract is antidilutive solely because it is out-of-the-money.

Under ASC 480, all written put options and forward purchase contracts are required to be classified as liabilities, regardless of the instruments' settlement alternatives. We have discussed the application of the reverse treasury method to these instruments with the FASB staff. They indicated that any gains or losses recognized during the period from marking these instruments to market should be reversed when applying the reverse treasury stock method. That is, any gains or losses that would not have been recognized during the period if the instruments had been exercised at the beginning of the period should be reversed from income available to common shareholders (i.e., the numerator of the EPS calculation) in calculating the dilutive effect of the instruments. That is, an entity should consider the combined effect of any numerator and denominator adjustments when determining whether an instrument is dilutive under the reverse treasury stock method.

The following example illustrates the effect of a written put option that may be settled in cash or stock:

**Illustration 4-16: Written put option that may be settled in stock or cash**

An entity writes a six-month put option on 10,000 shares of its common stock on the first day of the quarter. Under the terms of the put option, at the holder's discretion upon exercise, the entity must purchase the shares from the holder for $25 per share or pay the holder in either net shares or cash an amount equal to the excess of the strike price of $25 per share over the market price. Assume that the stock's average market price for the quarter was $20 per share. At the beginning of the quarter, the fair value of the option was $50,000, and on the last day of the quarter, the fair value of the option was $120,000. The effective tax rate is 35%.

Under ASC 480, the entity would account for the put option as a liability because the value of the contract moves in the opposite direction as the issuer's share price. The entity would recognize expense of $70,000 ($120,000 — $50,000) during the quarter for the change in the fair value of the option. For diluted EPS purposes, the entity would assume settlement in stock. Therefore, the denominator would be increased by 2,500 incremental shares calculated as follows:

Strike price of $25 — average market price of $20 = $5 spread

$5 x 10,000 shares = $50,000

$50,000 / $20 average market price = 2,500 additional shares

This calculation assumes that the entity would have to issue 2,500 shares during the quarter to net settle with the holder in shares. In addition, $45,500 ($70,000 expense net of income taxes) would be added back to the numerator because there would have been no expense if the contract was classified as equity. If this contract were antidilutive to the diluted EPS calculation, no adjustment would be made to either the numerator or denominator.

Note that for EPS purposes, the difference between the strike price and the market price ($50,000) for applying the reverse treasury stock method is computed using the average market price even though the expense recognized in the statement of operations ($70,000) was computed using the ending market price.

As noted in ASC 260-10-45-35 (excerpted above) and 45-70A (excerpted below), there is an exception to the general rule that requires that the dilutive effect of forward purchase contracts be calculated using the reverse treasury stock method.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Certain Redeemable Financial Instruments*

*260-10-45-70A*

Paragraph 480-10-45-4 provides guidance on calculating basic and diluted EPS if an entity has mandatorily redeemable shares of common stock or has entered into certain forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares of common stock.

Distinguishing Liabilities from Equity — Overall

*Other Presentation Matters*

*EPS*

*480-10-45-4*

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.

An obligation related to a forward purchase contract on a fixed number of the issuer's shares that requires physical settlement (i.e., by delivering cash in exchange for a fixed number of shares) is subject to unique accounting under ASC 480. See section A.5 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for discussion of the ASC 480 guidance referred to in ASC 260-10-45-35. Specifically, such transactions should be accounted for as if the issuer borrowed money to purchase its own stock. As such, in accordance with ASC 480-10-45-4, the numbers of shares underlying the forward contract are deducted from the denominator for purposes of calculating both basic and diluted EPS as of the date the issuer enters into the forward contract. As noted in ASC 260-10-45-70A and ASC 480-10-45-4, this guidance also applies to mandatorily redeemable shares of common stock. We believe this guidance also applies to prepaid forward purchase contracts.

Because this guidance applies to a forward purchase contract (or a prepaid forward purchase contract) on a *fixed* number of the issuer's shares that requires physical settlement in exchange for cash, if the number of shares to be purchased is variable, the fixed minimum number of shares that must be delivered, if any, should be considered. That is, only any fixed minimum number of shares underlying the contract should be deducted from the denominator for purposes of calculating both basic and diluted EPS as of the date the issuer enters into the contract. Any additional shares over the minimum that may need to be purchased do not impact the basic EPS denominator and should be considered for the diluted EPS calculation using the contingently issuable share guidance as discussed in section 4.8.

However, unless the forward purchase contract includes a mechanism to pass any dividends on the underlying shares back to the issuer, the "synthetic debt" is effectively a participating security that requires the application of the two-class method (see section 5). This is the case because even though the underlying shares are no longer considered outstanding under ASC 480, dividends must still be paid on those shares if the issuer declares a dividend. See section A.7.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for further discussion of ASC 480-10-45-4.

## 4.11 Purchased options (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Purchased Options*

*260-10-45-37*

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.

We believe this guidance to exclude purchased put and call options from the computation of diluted EPS because including them would be antidilutive applies even when the entity reports a net loss for the period. Including those instruments would decrease the number of shares in the denominator, which does not align with the guidance in ASC 260-10-45-16 (see section 4.1) requiring that the denominator in the diluted EPS calculation be increased.

Further, we believe that purchased options cannot be used to offset or be netted against the dilutive effect of any outstanding written options (including conversion options embedded in convertible instruments) as part of a hedge strategy when the options are considered separate freestanding financial instruments that are not otherwise combined for accounting purposes.[18]

However, if an entity determines that purchased and written options on its own stock must be combined into a single unit for accounting purposes or if the entity entered into a single contract that mirrors the economics of two separate instruments (such as a "capped call" option), the entity would need to determine whether the net effect of the single unit of account (or the single instrument) is dilutive or antidilutive to the EPS calculation. If the single unit of account (or single instrument) results in what effectively would be a net purchased option, exclusion from the EPS computation would be appropriate based on the above guidance.

For more information on combining freestanding financial instruments, see section 1.2.1.1 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***. Capped call options are further discussed in section 5.16 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***.

[18] This is consistent with BC112 of Statement 128.

# 5 Participating securities and the two-class method

## 5.1 Overview (updated August 2023)

Under ASC 260, entities that have multiple classes of common stock or have issued securities other than common stock that participate in dividends with common stock (i.e., participating securities) are required to apply the two-class method to compute EPS. The two-class method is an earnings allocation method under which EPS is calculated for each class of common stock and participating security considering both dividends declared (or accumulated) and participation rights in undistributed earnings as if all such earnings had been distributed during the period.

It is important to note that the use of the two-class method is required even if each class of common stock results in the same EPS. ASC 260-10-45-60B (see section 5.3) requires basic and diluted EPS to be presented for each class of common stock under the two-class method. An entity may disclose basic and diluted EPS for each class on the face of the income statement or may disclose one EPS amount on the face with clear disclosure that the amount applies to multiple classes of common stock. However, an entity should not assume multiple classes of common stock will result in the same EPS. Rather, before reaching such a conclusion, the entity must calculate basic and diluted EPS under the two-class method for each class.

Further, when determining whether an instrument is a participating security (as discussed further in section 5.2) and, therefore, the use of the two-class method is required to calculate EPS, it is not relevant whether the entity has paid or intends to pay dividends. As stated in ASC 260-10-45-66 (see section 5.3.1), earnings are "allocated to common stock and participating securities to the extent that each security may share in earnings" and "may not reflect the economic probabilities of actual distributions." That is, whether an instrument is a participating security depends on its contractual right to participation rather than the likelihood that it will participate. This would be the case even if the entity had legal, regulatory or other contractual restrictions on its ability to pay dividends (e.g., debt covenants, third-party or regulatory approval).

The following sections provide guidance to assist with the determination of whether a security is a participating security and how to apply the two-class method to calculate EPS.

## 5.2 Determining whether a security is a participating security

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

***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.

*Other Presentation Matters*

*Participating Securities and the Two-Class Method*

*260-10-45-59A*

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.

*260-10-45-60*

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.

*260-10-45-60A*

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.

A participating security is any security that may participate in undistributed earnings with common stock. As discussed above, it is not relevant whether the entity has paid or intends to pay dividends when making this determination. Also note that the determination of whether a security is a participating security is based on whether the security shares in dividends in its current form. For example, options, warrants, forwards or other contracts to issue common stock may be participating securities if they meet the definition of a participating security in their current form (i.e., prior to exercise or settlement). In accordance with ASC 260-10-45-60A, any securities meeting the definition of a participating security are included in the computation of basic EPS using the two-class method, regardless of whether the securities are convertible, nonconvertible or potential common stock.

For example, nonvested share-based payment awards that contain rights to receive nonforfeitable dividends are participating securities and, thus, should be included in the two-class method of computing EPS. These awards are considered participating securities because the award holders participate in distributions of earnings with common shareholders from the date the awards are granted because no service has to be rendered to earn the dividends. By comparison, nonvested share-based payment awards that contain rights to receive dividends only if the award fully vests do not represent a participation right. These awards are not considered participating securities because the award holder does not have the right to retain the dividend unless the requisite service has been rendered.

The characterization (i.e., the form) of a payment on a security that is required to be made when dividends are paid on common stock is not relevant in determining whether the security is participating. For example, a convertible debt instrument may provide for "contingent interest" in which additional interest payments must be made if dividends are paid on the issuer's common stock. Although the convertible debt agreement may characterize these payments as "interest," that does not change the fact that the payments are required because of dividends paid on common stock and, therefore, the instrument is participating (and the contingent interest feature likely also is an embedded derivative — see further discussion in section 2.2.6.1 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, and in section 3.10.4 of our FRD, ***Derivatives and hedging***). However, as discussed in

section 5.2.1, if upon payment of a dividend on common shares, the form of the participation is a reduction in the conversion price of the convertible debt instrument, that "payment" normally would not make the instrument a participating security (unless the instrument is mandatorily convertible).

The graphic below shows examples of participating securities:

| Security | Participating feature |
|---|---|
| Preferred stock | Receives dividends based on dividends paid on common stock[19] |
| Restricted stock units | Provides for payment of nonforfeitable dividends |
| Stock options and other options and warrants on common stock or preferred stock | Receives nonforfeitable dividends paid on the underlying stock prior to exercise or settlement |
| Convertible debt | "Interest" that must be paid upon declaration of a common stock dividend |
| Partnership interests | Issued by publicly traded master limited partnerships |
| Forward sale contracts to sell issuer's common or participating preferred shares | An adjustment to the strike price when dividends are paid on the underlying shares |
| Mandatorily convertible debt or preferred stock | An adjustment to the strike price when dividends are paid on underlying shares |
| Written put options and certain forward purchase contracts | Provides for payment of nonforfeitable dividends |

## 5.2.1 Convertible instruments and option contracts

### FASB amendment

With ASU 2020-06, the FASB simplified an issuer's accounting for convertible instruments, as well as simplified and improved the consistency of the diluted EPS calculation. The amendments eliminated the beneficial conversion and cash conversion accounting models in ASC 470-20 that require separate accounting for embedded conversion features. Accordingly, a consequential amendment was made to delete ASC 260-10-45-64 (shown as pending content below), which referred to the beneficial conversion feature guidance in ASC 470-20.

The ASU was effective for public business entities (excluding smaller reporting companies) for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein.

[19] Regardless of dividends paid on common stock, preferred stock may receive a contractual fixed dividend that often must be paid before any dividends can be paid on common stock. However, we do not believe contractual fixed dividends should be considered when determining whether a preferred stock instrument is a participating security because the payment of those dividends, and any related preference, do not depend on dividends paid on common stock.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters [Selected excerpts]*

*Participating Securities and the Two-Class Method*

*260-10-45-62*

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.

*260-10-45-64*

A dividend equivalent that is applied to reduce the conversion price or increase the conversion ratio of a convertible security may represent a contingent beneficial conversion feature. Guidance on whether such a dividend equivalent represents a contingent beneficial conversion feature is presented in Subtopic 470-20. That Subtopic also establishes the accounting required for contingent beneficial conversion features.

**Pending Content:**

**Transition Date:** *(P) December 16, 2021; (N) December 16, 2023* **| Transition Guidance:** 815-40-65-1

*260-10-45-64*

Paragraph superseded by Accounting Standards Update No. 2020-06.

A security convertible into the common stock of the issuer (e.g., convertible debt) or an option contract to purchase the issuer's common stock that includes a provision that reduces the conversion price based on the dividends declared by the issuer are not participating securities (unless the instrument is mandatorily convertible, as discussed below). The basis for this conclusion is the fact that the holder's ability to participate in the undistributed earnings of the issuer is contingent on the conversion of the convertible security to equity or exercise of the outstanding option (which would only happen if the option is in-the-money) and, therefore, does not represent a participation right.

If a convertible security has a mandatory conversion date, and dividends or dividend equivalents are transferred to the holder of the convertible security in the form of a reduction of the conversion price or an increase in the conversion ratio of the security, then such a feature would represent a participation right. This is because the transfer of value is not contingent on a decision to exercise (similar to a forward sale contract discussed in section 5.2.2).

Before the adoption of ASU 2020-06, an issuing entity should assess whether a dividend equivalent that is applied to reduce the conversion price or increase the conversion ratio of a convertible security is a contingent beneficial conversion feature based on the guidance in ASC 470-20. See Appendix D of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)***, for further discussion regarding the evaluation of beneficial conversion features. After the adoption of ASU 2020-06, the beneficial conversion feature guidance in ASC 470-20 is eliminated.

In accordance with ASC 260-10-45-62, nonvested share-based payment awards would not be considered participating securities if the dividends transferred could only be applied as a reduction in the exercise price of the award. These types of awards are not considered participating securities because the holder does not have the nonforfeitable right to participate in the distribution of earnings with the common shareholders unless the award is exercised.

## 5.2.2 Forward sale contracts

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Participating Securities and the Two-Class Method*

*260-10-45-63*

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.

Forward sale contracts discussed above are contracts that involve the mandatory issuance of equity securities in the future based on predetermined fixed terms. In these types of contracts, the issuance of equity instruments is not conditional. These types of instruments are viewed differently than those involving conditional transfers of equity instruments.

A forward sale contract to issue an entity's own shares that contains a provision that reduces the contract price per share when dividends are declared on the issuing entity's common stock normally is a participating security when the terms of the forward are fixed (see section 5.2.4 for discussion of variable-share forward contracts). This conclusion is based on a view that the adjustment to the contract price per share results in a noncontingent transfer of value to the counterparty for the dividends declared during the contract through a reduction in the forward purchase price per share. This is in contrast to nonmandatorily convertible instruments and option contracts discussed in section 5.2.1 where the transfer of value to the holder of the security for the dividends declared is contingent on the conversion of the convertible security or exercise of the outstanding option. Accordingly, the earnings of the entity must be allocated to a forward sale contract with predetermined fixed terms using the two-class method if the forward price is adjusted for dividends.

## 5.2.3 Accelerated share repurchase programs

ASC 505-30 and ASC 260 provide the following examples of an accelerated share repurchase program:

**Excerpt from Accounting Standards Codification**

Equity — Treasury Stock

*Recognition*

*Accelerated Share Repurchase Programs*

*505-30-25-5*

An accelerated share repurchase program is a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program.

*505-30-25-6*

An entity shall account for such an accelerated share repurchase program as the following two separate transactions:

a. As shares of common stock acquired in a treasury stock transaction recorded on the acquisition date

b. As a forward contract indexed to its own common stock. Subtopic 815-40 provides guidance on the accounting for contracts that are indexed to an entity's own common stock.

Example 1 (see paragraph 505-30-55-1) provides an illustration of an accelerated share repurchase program that is addressed by this guidance.

***Implementation Guidance and Illustrations***

***Example 1: Accelerated Share Repurchase Program***

*505-30-55-1*

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.

*505-30-55-2*

The treasury stock purchase is as follows.

*505-30-55-3*

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.

*505-30-55-4*

The forward contract is as follows.

*505-30-55-5*

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.

*505-30-55-6*

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.

*505-30-55-7*

See Example 13 (paragraph 260-10-55-88) for the effect on earnings per share (EPS) for this Example.

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 13: Accelerated Share Repurchase Programs*

*260-10-55-88*

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.

*260-10-55-89*

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.

As noted in ASC 505-30-25-6, accelerated share repurchases are accounted for as two separate transactions: (1) as common stock acquired in a treasury stock transaction and (2) as a forward sale contract indexed to the issuer's own stock. Entities typically utilize the treasury stock method to calculate the dilutive effect of a forward sale contract on EPS (see section 4.3). However, entities that enter into an accelerated share repurchase program should consider whether the forward sale contract is a participating security because of a dividend adjustment feature (i.e., the contract settlement price adjusts based on dividends declared). As noted in section 5.2.2, such a provision in a forward sale contract with predetermined fixed terms generally should be viewed as a participation right because the transfer of value on declaration of a dividend is not contingent as it would be for an option contract. Section 5.2.4 discusses the evaluation of such a provision on variable-share forward contracts as a participation right.

When the participation right is not contingent, the two-class method is required for calculating EPS. In the example above, assuming no securities other than the entity's common stock and the forward sale contract participated in dividends, the earnings (distributed and undistributed) of the entity would be allocated between the common shares of the entity and the forward sale contract.

For further discussion on accelerated share repurchase programs, see section 5.9 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***.

## 5.2.4 Variable-share forward contracts

A variable-share forward contract has a fixed forward price, but the number of shares underlying the forward (i.e., the number of shares to be delivered at settlement) varies. The number of shares is determined by dividing the contract price by some measure of share price (e.g., share price at period-end, an average share price over a certain period). A variable-share forward contract is sometimes issued concurrently with a debt or preferred security as a component of a unit structure. Refer to section 6.5 for further discussion of unit structures.

Some variable-share forward contracts contain a provision that requires an adjustment to the contract price when dividends are declared. The determination of whether the price adjustment feature constitutes a participation right and, thus, whether an entity is required to use the two-class method to calculate EPS, will depend on the relevant terms of the variable-share forward contract. This assessment is generally more complicated than the evaluation of a forward contract with predetermined fixed terms as discussed in section 5.2.2.

The following is an illustration of certain terms of a typical variable-share forward contract:

**Illustration 5-1: Effect of variable-share forward contracts on EPS**

Company A enters into a variable-share forward contract in which the counterparty (investor) agrees at the end of three years to purchase from the issuer for $25 a number of shares of the issuer's common stock as follows (typically, the share prices in the following provisions will be adjusted by the amounts of any dividends declared by Company A in excess of specified amounts during the term of the contract):

- If the common stock price at the settlement date is at or above $30, the investors will receive 0.83 shares of stock upon settlement of the forward contract.
- If the price of a share of the common stock at the settlement date is at or below $25, the investors will receive one share of stock upon settlement of the forward contract.
- If the price of a share of Company A common stock at the settlement date is between $25 and $30, the investors will receive a number of shares of issuer common stock based on the stated amount of $25 divided by the common stock price at the settlement date. For example, if the stock price is $28, the investors will receive approximately 0.89 (25 / 28) shares of stock upon settlement of the forward contract.

To determine the appropriate method to calculate the EPS effect of the variable-share forward contract, entities must first determine whether the variable-share forward contract contains a provision that requires an adjustment to the contract price when dividends are declared. If there is such an adjustment feature, the issuer must then determine whether the feature constitutes a participation right.

We believe that the variable-share forward contract described above could be recharacterized as two option contracts (i.e., a combination of a written call option and a purchased put option, each with different strike prices) by considering the profit or loss potential of the investor as follows:

| Ending share price | Contractual terms | Equivalent option positions |
|---|---|---|
| Less than $25 | Investor must purchase shares at $25. | Issuer has purchased a put option from investor on one share at $25. |
| Between $25 and $30 | Investor pays $25 and receives shares with a fair value of $25. | No economic benefit or detriment exists. |
| Greater than $30 | Investor must purchase 0.83 shares for $25 (an effective price of $30 per share). | Issuer has sold a call option to the investor for 0.83 shares at $30 per share. |

The variable-share forward contract typically includes a provision that adjusts the strike prices in the event that dividends in excess of a specified amount are paid by the entity. For example, assume that an adjustment is required to the strike price in the contract if the issuer pays a dividend in excess of $1 per share in any given year. Therefore, if the issuer declares a dividend of $2 per share during the year, the strike prices will adjust from $25 and $30 to $24 and $29, respectively. The forward contract provides that the investor will always pay $25 at settlement, and therefore, the investor will receive between 1.04 shares and 0.86 shares (instead of between 1 and 0.83 shares) upon settlement.

Even after the adjustment for the dividend, there is a range of share prices between which the investor will not receive the benefit of the dividend (commonly referred to as the "dead zone"). Specifically, after the dividend is paid, if the stock price is between $24 and $29, the investor will receive $25 in value in exchange for $25. That is because, as discussed above, the economics of the forward contract are represented by the previously described purchased put and written call options.

As discussed in section 5.2.1, adjustments to the strike prices of option contracts are not participation features because the holder must convert the security to benefit from the dividend adjustment and, therefore, may not benefit from the adjustment if the option is out-of-the-money. Similarly, the investor will not benefit from dividend adjustments under the variable-share forward contract when the share price at the maturity of the variable-share forward contract is within the "dead zone."

As a consequence, we believe that it is reasonable to conclude that a variable-share forward contract is not a participating security when it includes a substantive share price range in which there is no benefit from the strike price adjustment (e.g., if the range between the share prices is at least 20% of the issuance date stock price), and it is reasonably possible that the share price would be within that range upon maturity of the contract. In that case, the dilutive effect of the variable-share forward should be calculated using the treasury stock method (see section 4.3) with no effect on basic EPS until the contract is settled.

The assessment of whether the variable-share forward contract has a participation feature should be made at the inception of the arrangement (or upon modification) based on the facts and circumstances, including the size of the range in which the investor would not receive the benefit of strike price adjustment, the relationship of the range to the issuance date stock price, the term of the contract, historical and expected dividends, and the volatility of the underlying stock price (higher volatilities might require a wider range).

## 5.3 Application of the two-class method

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Other Presentation Matters***

***Participating Securities and the Two-Class Method***

***260-10-45-60B***

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.

***260-10-45-70***

See Example 9 (paragraph 260-10-55-71) for an illustration of this guidance.

As noted above, under the two-class method both basic and diluted EPS are required to be calculated for each class of common stock and participating security considering both dividends declared (or accumulated) and participation rights in undistributed earnings. The two-class method results in an allocation of all undistributed earnings as if all those earnings were distributed, which can result in a substantial reduction in both basic and diluted EPS.

ASC 260-10-45-60B only requires presentation in the financial statements of basic and diluted EPS under the two-class method for each class of common stock. That is, although basic and diluted EPS would be calculated for multiple classes of common stock and each participating security, presentation in the financial statements is only required for classes of common stock. Disclosure of the basic and diluted EPS amounts for a participating security is permitted but not required.

The following example illustrates the calculation of basic EPS using the two-class method. Also see Example 9 from ASC 260 in section 5.3.3.1 (excerpt) and Appendix E.

**Illustration 5-2: Calculation of basic EPS using the two-class method**

An example of the two-class method of computing basic EPS for an entity that has more than one security is presented below. The assumptions for the example are as follows:

- Net income is $1,250,000
- 125,000 shares of $25 par value common stock are outstanding for the full period
- 35,000 shares of $50 par value nonconvertible, participating preferred stock are outstanding for the full period
- The preferred stock is entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock
- Preferred stockholders have been paid $175,000 ($5.00 per share)
- Common stockholders have been paid $500,000 ($4.00 per share)
- After the common stock has been paid a dividend of $4 per share, the preferred stock then participates in any additional dividends on a 40:60 per-share basis with common stock. In the following example, if each common share would receive an additional dividend of $3.88 ($484,550 in total), each preferred share would receive $2.58 ($90,450 in total).

Basic EPS would be computed as follows:

| | | |
|---|---|---|
| Net income | | $ 1,250,000 |
| Less dividends paid: | | |
| Preferred ($5 x 35,000 shares) | $ 175,000 | |
| Common ($4 x 125,000 shares) | 500,000 | |
| Total dividends paid | | 675,000 |
| Undistributed earnings | | $ 575,000 |

Allocation of undistributed earnings:

*To preferred:*
0.4 (35,000) ÷ [0.4 (35,000) + 0.6 (125,000)] x $575,000 = $90,450
$90,450 ÷ 35,000 shares = $2.58 per share

*To common:*
0.6 (125,000) ÷ [0.4 (35,000) + 0.6 (125,000)] x $575,000 = $484,550
$484,550 ÷ 125,000 shares = $3.88 per share

| Basic per-share amounts: | Preferred stock | Common stock |
|---|---|---|
| Distributed earnings — dividends | $ 5.00 | $ 4.00 |
| Undistributed earnings — allocated | 2.58 | 3.88 |
| Totals | $ 7.58 | $ 7.88 |

Section 5.3.1 discusses allocation of undistributed earnings to a participating security. Also refer to section 5.3.3 for a discussion of computing diluted EPS under the two-class method.

## 5.3.1 Allocation of undistributed earnings to a participating security (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Other Presentation Matters***

***Participating Securities and the Two-Class Method***

*260-10-45-65*

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.

*260-10-45-66*

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.

Undistributed earnings for a period should 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 current period earnings had been distributed. If the terms of a 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 though all of the earnings for the year were distributed, no allocation of that period's earnings would be made to the participating security.

We believe that, while this is not explicit in ASC 260, the allocation of undistributed earnings is generally based on the weighted average number of common shares and participating securities outstanding for the period. That is, the allocation would not be based on the number of shares or participating securities outstanding at the end of the period. This allocation would be consistent with the weighted average principles described elsewhere in ASC 260 (e.g., ASC 260-10-45-10 in section 3.1). This weighted average approach is shown in Illustration 5-9 in section 5.4.4.

The following example illustrates the allocation of earnings to participating securities under the presumption that all earnings are distributed during the period. Also see Example 9 from ASC 260 in section 5.3.3.1 (excerpt) and Appendix E.

**Illustration 5-3: Allocation of undistributed earnings to a participating security**

Assume that Company ABC had 100,000 shares of common stock and 50,000 shares of preferred stock outstanding during 20X1. Each share of preferred stock has a par value of $1. Net income for 20X1 was $65,000. No dividends were declared during the year. Under the terms of the preferred stock agreement, preferred stockholders are entitled to an 8% noncumulative dividend before dividends can be declared and paid to common stockholders. Preferred stockholders participate in all other distributions on a one-for-one basis with common stockholders.

The preferred stock is considered a participating security because it is entitled to dividends upon payment of dividends to common stockholders. Basic EPS under the two-class method for 20X1 would be computed as follows:

| | |
|---|---|
| Net income | $ 65,000 |
| Less: dividends paid | 0 |
| Undistributed 20X1 earnings | $ 65,000 |

Allocation of undistributed earnings:

To preferred stockholders:

Contractual dividends to preferred shareholders are $4,000, which were calculated as $1 par value x 8% x 50,000 shares.

[50,000 ÷ (50,000 + 100,000)] × ($65,000 − $4,000) = $20,333

($4,000 + $20,333) ÷ 50,000 shares = $0.49 per share

To common stockholders:

[100,000 ÷ (50,000 + 100,000)] × ($65,000 − $4,000) = $40,667

$40,667 ÷ 100,000 shares = $0.41 per share

Basic EPS amounts:

| | Common stock | Preferred stock |
|---|---|---|
| Distributed earnings | $ 0.00 | $ 0.00 |
| Undistributed earnings | 0.41 | 0.49 |
| Total | $ 0.41 | $ 0.49 |

Although no dividends were declared or paid to common stockholders during 20X1, the allocation of the contractual dividend to preferred stockholders (before the allocation of any earnings to common stockholders) is required by EPS guidance despite the fact that it is inconsistent with actual distributions to the preferred stockholders during the period.

As described above, under the two-class method, earnings are allocated to common stock and participating securities to the extent that each security shares in earnings as if all of the earnings for the period had been distributed. In order for common stockholders to receive any earnings, the preferred stockholders must first receive the 8% dividend specified in the terms of the preferred stockholder agreement. Any remaining earnings are allocated to preferred and common stockholders based on their relative participation rights.

As noted in ASC 260-10-45-65, further interpretive guidance on participating securities and undistributed earnings is included in ASC 260-10-55-24 through 55-31 below:

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Participating Securities and Undistributed Earnings*

*260-10-55-23A*

Paragraphs 260-10-55-24 through 55-31 provide additional guidance on the requirements in paragraph 260-10-45-65 related to the allocation of undistributed earnings to participating securities.

*260-10-55-24*

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.**

*260-10-55-25*

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.

*260-10-55-26*

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.

*260-10-55-27*

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.

*260-10-55-28*

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.

*260-10-55-29*

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.

*260-10-55-30*

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.

*260-10-55-31*

See Example 9 (paragraph 260-10-55-71) for an illustration of this guidance.

ASC 260-10-55-24 notes that disclosure of a security's participation rights may be required under ASC 505-10. ASC 260-10-55-25 states that 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, the undistributed earnings should be allocated between the common stock and the participating security on a one-to-one per-share basis. ASC 260-10-55-26 through 55-30 discuss the application of the two-class method when participation is contingent on a specific event, which will vary based on the facts and circumstances.

### 5.3.2 Allocation of undistributed losses under the two-class method (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Participating Securities and the Two-Class Method*

*260-10-45-67*

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.

*260-10-45-68*

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.

The guidance above applies to the allocation of undistributed losses in periods in which an entity has a net loss or when an entity has undistributed losses as a result of dividends exceeding net income. Under this guidance, an entity would allocate losses to a participating security only if the security had a contractual obligation to share in the losses of the entity on a basis that was objectively determinable.

Even if a security participates in earnings on an objectively determinable, nondiscretionary basis (as discussed in section 5.3.1), that does not necessarily mean it participates in losses on a contractual, nondiscretionary basis. Furthermore, it is unusual for securities other than common stock to have contractual obligations that require participation in an entity's losses. Accordingly, losses generally should not be allocated to participating nonvested share-based payment awards, including restricted stock units. For further discussion of the application of the two-class method to participating share-based payment awards, see section 5.4.

In some cases, multiple classes of common stock may have different dividend participation rights but share equally in residual net assets. When this occurs, we believe undistributed losses would be allocated equally to each class of common stock. Further, as discussed in Section 5.3.1 for the allocation of undistributed earnings, we believe the allocation of undistributed losses should generally be based on the weighted average number of common shares and participating securities outstanding for the period. That is, the allocation would not be based on the number of shares or participating securities outstanding at the end of the period.

### 5.3.3 Diluted EPS under the two-class method

ASC 260 does not specifically discuss or provide an example of how to compute diluted EPS under the two-class method. We believe the dilutive effect of each participating security or second class of common stock should be calculated using the more dilutive of the following approaches:

- The treasury stock method, reverse treasury stock method or if-converted method, as applicable, provided a participating security or second class of common stock is a potential common share
- The two-class method, assuming a participating security or second class of common stock is not exercised or converted

Under the treasury stock method, reverse treasury stock method or if-converted method, the dilutive effect of other potential common shares (e.g., stock options) should be considered in conjunction with the antidilution sequencing provisions in ASC 260 (see section 4.2). Under the two-class method, the dilutive effect of other potential common shares is determined in conjunction with the antidilution sequencing provisions in ASC 260 and undistributed earnings are reallocated between common shares and participating securities.

Application of the treasury stock method and other methods described in the first bullet above assumes conversion or exercise as of the beginning of the period while the two-class method assumes that the securities remain in their current form (i.e., are not exercised or converted). Diluted EPS must be calculated under both methods and the calculation that results in the most dilutive (i.e., lowest) EPS amount for the common stock is reported in the financial statements.

As previously discussed in section 5.3, although diluted EPS for a second class of common stock and each participating security would be calculated using the two-class method, disclosure in the financial statements is only required for classes of common stock in accordance with ASC 260-10-45-60B (see section 5.3). Disclosure of the diluted EPS amount for a participating security is permitted, but not required. Illustration 5-9 in section 5.4.4 depicts the concepts discussed above.

#### 5.3.3.1 Convertible participating securities

ASC 260 requires entities with participating convertible securities to apply the two-class method to compute basic EPS. Entities should apply the guidance in section 5.3.3 to compute diluted EPS.

The following example from ASC 260 illustrates the computation of basic EPS for convertible participating securities using the two-class method. See Illustration 5-4 below where we have continued this example to illustrate the computation of diluted EPS. For Example 9 in its entirety, refer to Appendix E.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Implementation Guidance and Illustrations***

***Example 9: Participating Securities and the Two-Class Method [Selected excerpts]***

***260-10-55-72***

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***

***260-10-55-73***

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) ÷ [0.4(5,000) + 0.6(10,000)] x $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)] x $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 |

In the example above, basic EPS is presented for both the Class A common stock and the participating security (convertible preferred stock). The presentation of EPS is required only for each class of common stock in accordance with ASC 260-10-45-60B (see section 5.3). However, the presentation of basic and diluted EPS for a participating security other than common stock is not precluded.

In order to compute diluted EPS, the effect of potential common shares should be included in the computation. In the event the entity has potential common shares, consideration should be given to the antidilution sequencing guidance in ASC 260 (see section 4.2). This requires the issuer to consider each issue or series of issues of potential common shares in sequence from the most dilutive to the least dilutive.

If including the next group of potential shares in the sequence results in a higher EPS than prior to its inclusion, the potential shares are antidilutive, and they should not be included in the calculation of diluted EPS. That is, dilutive potential common shares with the lowest "earnings per incremental share" should be included in diluted EPS before those with higher earnings per incremental share. Therefore, this normally requires the application of the treasury stock method first followed by the application of the if-converted method. Options, warrants and share-based payment awards generally will be included first when the treasury stock method does not adjust the numerator (i.e., earnings available to common shareholders) of the EPS computation. However, the numerator may be adjusted under the treasury stock method as described in sections 4.9 (before the adoption of ASU 2020-06), 4.9A (after the adoption of ASU 2020-06) and 4.10. Because the use of the if-converted method for participating securities can affect the numerator (due to the requirement to add back certain adjustments required in ASC 260-10-45-40 (see section 4.6)), it is important to consider the sequencing guidance in ASC 260 because the inclusion of the convertible participating security in the computation of diluted EPS may be antidilutive.

ASC 260 does not contain specific guidance on calculating diluted EPS using the treasury stock method and the if-converted method for participating securities that are also potential common shares. The following calculation demonstrates one acceptable application of the guidance:

**Illustration 5-4: Calculation of diluted EPS when there is a participating security**

To illustrate the calculation of diluted EPS, assume that Entity A in the example above also had 750 stock options outstanding that resulted in the inclusion of 250 additional shares in the computation of diluted EPS based on the application of the treasury stock method (see section 4.3 for a discussion of the treasury stock method). The computation of diluted EPS using the treasury stock method for the stock options and the if-converted method for the convertible preferred stock follows:

| | Income to Class A | Class A shares | EPS |
|---|---|---|---|
| As reported — basic | $ 35,000[(a)] | 10,000 | $ 3.50 |
| Undistributed earnings allocated to convertible preferred | 3,000 | | |
| Subtotal[(b)] | 38,000 | 10,000 | $ 3.80 |
| Options | - | 250 | |
| | 38,000 | 10,250 | $ 3.71 |
| Convertible preferred[(c)] | 27,000 | 10,000 | |
| | $ 65,000 | 20,250 | $ 3.21 |

See ASC 260-10-55-72 and 55-73 above for the background related to this example and for the components of the EPS calculation. Based on this analysis, Entity A would report diluted EPS of $3.21. If the diluted EPS calculated using the two-class method was less (which could be the case in the example above if the preferred stock participated in a higher percentage of dividends than the common shareholders of Entity A, or the preferred stock converted on a 1:1 basis), the two-class method should be used.

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(a) Calculated as $26,000 (Class A dividends paid) + 9,000 (allocation of undistributed earnings to common) in ASC 260-10-55-73.

(b) This is the control number for calculating diluted EPS. See ASC 260-10-45-20 in section 4.2.

(c) Because the EPS effect of adding the convertible preferred securities ($27,000 / 10,000 = $2.70) to the diluted EPS calculation is less than diluted EPS before consideration of the convertible preferred securities, the application of the if-converted method is dilutive and, therefore, should be used in this example.

#### 5.3.3.2 Convertible participating class of common stock

Some entities have multiple classes of common stock (e.g., Class A and Class B common stock) that participate in dividends with one class convertible into the other class of common stock. In these cases, the calculation of basic EPS should be performed using the two-class method. However, it is less clear how diluted EPS should be calculated when multiple classes of common stock are outstanding.

We have discussed this situation informally with the FASB staff,[20] who indicated that the if-converted method should be used (if dilutive) to compute diluted EPS for the main class of common stock (generally the class of common stock into which the other classes will be converted), and diluted EPS for the other classes should be computed using the two-class method, as if all the earnings were distributed to each class of common stock based on their contractual rights. We believe this approach should be followed unless the two-class method of computing diluted EPS is more dilutive than the if-converted method for the main class of common stock. In computing diluted EPS using the two-class method, consideration should be given to the potential common shares of each class of stock when determining the earnings allocation.

ASC 260 does not contain specific guidance on calculating diluted EPS using the treasury stock and if-converted methods for participating securities that are also potential common shares. The following calculation demonstrates one acceptable application of the guidance and illustrates the calculation of basic and diluted EPS using the two-class method:

**Illustration 5-5: Calculation of basic and diluted EPS using the two-class method, including application of the if-converted method to a participating security**

Assume that Company XYZ had 10,000 shares of Class A common stock and 5,000 shares of Class B common stock outstanding during 20X1 and reported net income of $65,000 for 20X1. Each share of Class B common stock is convertible into one share of Class A common stock. The Class B common stock is entitled to 95% of any dividend paid to the holders of the Class A common stock. For 20X1, the Class A shareholders have been paid $26,000 (or $2.60 per share), and the Class B shareholders have been paid $12,350 (or $2.47 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 | |
| Class B common | 12,350 | |
| Total dividends paid | | 38,350 |
| Undistributed 20X1 earnings | | $ 26,650 |

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[20] This view was also discussed in an SEC staff speech by Cathy Cole, 11 December 2006.

Allocation of undistributed earnings:

To Class A common:

1(10,000) ÷ [0.95(5,000) + 1(10,000)] × $26,650 = $18,068

$18,068 ÷ 10,000 shares = $1.81 per share

To Class B common:

0.95(5,000) ÷ [0.95(5,000) + 1(10,000)] × $26,650 = $8,582

$8,582 ÷ 5,000 shares = $1.72 per share

Basic EPS amounts:

| | Class A | Class B |
|---|---|---|
| Distributed earnings | $ 2.60 | $ 2.47 |
| Undistributed earnings | 1.81 | 1.72 |
| Total | $ 4.41 | $ 4.19 |

As noted above, we believe that the issuer should compute diluted EPS for the Class A common stock, assuming conversion of the Class B common stock (which is dilutive in this example), and include the effect of other potential common shares. While not more dilutive in this instance, the two-class method should be followed for the Class A common stock if it were to produce a lower diluted EPS amount. Assume that Company XYZ also had 750 options on Class A common shares outstanding that resulted in the inclusion of 300 additional shares in the computation of diluted EPS based on the application of the treasury stock method (see section 4.3 for a discussion of the treasury stock method). There are no options on Class B common stock outstanding. The computation of diluted EPS would be as follows:

**Diluted EPS for Class A common stock**

Under the if-converted method, the issuer assumes that all the Class B common stock has been converted to Class A common stock. Therefore, all the earnings available to common shareholders will be allocated to the Class A shareholders (including the dilutive effect of potential common shares resulting from the options).

| | Income to Class A | Class A shares | EPS |
|---|---|---|---|
| As reported — basic | $ 44,068 | 10,000 | $ 4.41 |
| Undistributed earnings allocated to Class B common | 8,582 | | |
| Subtotal (a) | 52,650 | 10,000 | $ 5.27 |
| Options | - | 300 | |
| | 52,650 | 10,300 | $ 5.11 |
| B common (b) | 12,350 | 5,000 | |
| | $ 65,000 | 15,300 | $ 4.25 |

(a) This is the control number for calculating diluted EPS. See ASC 260-10-45-20 in section 4.2.

(b) Because the EPS effect of adding the B common securities ($12,350 / 5,000 = $2.47) to the diluted EPS calculation is less than diluted EPS before consideration of the B common securities, the application of the if-converted method is dilutive and, therefore, should be used in this example.

Based on the analysis above, Company XYZ would report diluted EPS of $4.25, which is calculated using the if-converted method. In the event that the diluted EPS calculated using the two-class method was more dilutive, then the two-class method should be used.

**Diluted EPS for Class B common stock**

Finally, the issuer must include in the calculation of diluted EPS for the Class B common stock the effect of the potential common shares (addition of 300 potential Class A common shares) in the allocation of undistributed earnings as follows:

Allocation of undistributed earnings:

To Class B common:

0.95(5,000) ÷ [0.95(5,000) + 1(10,300)] × $26,650 = $8,411

$8,411 ÷ 5,000 shares = $1.68 per share

| | Class B |
|---|---|
| Distributed earnings | $ 2.47 |
| Undistributed earnings | 1.68 |
| Total | $ 4.15 |

Based on the analysis above, Company XYZ would report EPS of the following (note that the presentation of EPS is required for each class of common stock):

| | Class A | Class B |
|---|---|---|
| Basic EPS | $ 4.41 | $ 4.19 |
| Diluted EPS | $ 4.25 | $ 4.15 |

Note that we believe the presentation of diluted EPS for the Class B common stock is required, although it is assumed that the Class B common stock was converted into Class A common stock in the calculation of Class A common stock diluted EPS.

### 5.3.4 Equity restructurings

ASC 718 defines an equity restructuring as 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." We generally do not believe that a contractual antidilution provision that provides for cash payments or adjustments to the terms of an instrument in the event of an equity restructuring as defined in ASC 718 represents a right to participate in earnings. We believe that equity restructurings should affect only the outstanding shares (i.e., the denominator) in the calculation of EPS. This is consistent with the approach discussed in ASC 260-10-55-12 (see section 7.3.1) for stock dividends and stock splits in that there is no adjustment to the numerator in the EPS calculation as a result of these transactions.

### 5.3.5 Discontinued operations

As discussed further in section 7.1, entities that report discontinued operations must present basic and diluted per-share amounts for that line item either on the face of the statement of operations or in the notes to the financial statements in accordance with ASC 260-10-45-3. Questions have arisen as to how to apply the two-class method of computing EPS when an entity has discontinued operations. Specifically, how should earnings (losses) be allocated to participating securities if there is a loss from continuing operations but net income after giving consideration to the income from discontinued operations? Alternatively, how should earnings (losses) be allocated to participating securities if there is income from continuing operations but a net loss after giving consideration to the loss from discontinued operations?

The questions generally stem from the provisions of ASC 260-10-45-67 through 45-68 (see section 5.3.2) that indicate that an entity would allocate losses to a participating security (whether or not convertible into common stock) in periods of net loss if, based on the contractual terms, the participating security has a contractual obligation to share in the losses of the issuing entity on a basis that is objectively determinable. In practice, it is uncommon for a participating security, including a nonvested share-based payment award, to have a contractual obligation to share in losses of the issuing entity. Accordingly, an entity must determine whether there is income to allocate to the participating security (i.e., because losses generally would not be allocated). If there is a loss from continuing operations but net income after giving consideration to the income from discontinued operations, or income from continuing operations but a net loss after giving consideration to the loss from discontinued operations, which measure should be used to determine if there is income to allocate?

Although ASC 260-10-45-18 (see section 4.2) indicates that an entity that reports a discontinued operation should use income from continuing operations as the "control number" in determining whether potential common shares are dilutive, we believe this represents guidance for calculating the denominator in the diluted EPS calculation. While ASC 260 does not specifically address the application of the two-class method when an entity has discontinued operations, we generally believe undistributed net income (loss) (i.e., income (loss) from continuing operations plus income (loss) from discontinued operations) should be the basis for determining whether undistributed earnings are allocated to participating securities. That is, if an entity has undistributed net income, the participating securities will be allocated a portion of both the income or loss from continuing operations and discontinued operations. Conversely, if an entity has an undistributed net loss, none of the income or loss from either continuing operations or discontinued operations should be allocated to the participating securities (unless, in rare cases, there are contractual obligations for the securities to participate in an entity's losses, see section 5.3.2). The following examples illustrate these concepts:

**Illustration 5-6: Application of the two-class method in a period of net loss when an entity reports discontinued operations**

Assume the following for an entity:

- Income from continuing operations of $1,000
- Loss from discontinued operations of $1,500
- Common shares outstanding during the period of 1,000 with an average price of $5 per share
- Participating restricted stock units outstanding during the period of 200 that participate in dividends with common shareholders on a 1:1 basis. The participating securities do not participate in losses of the entity.
- Average unrecognized compensation of $180 related to the restricted stock units
- No dividends declared during the period

Basic and diluted EPS for the common shareholders would be calculated as follows:

| | | Basic EPS | Diluted EPS | |
|---|---|---|---|---|
| Income from continuing operations | $ 1,000 | $ 1.00 | $ 0.86 | (a) |
| Loss from discontinued operations | (1,500) | (1.50) | (1.29) | (b) |
| Net loss | $ (500) | $ (0.50) | $ (0.43) | |

In this example, the entity has an undistributed net loss of $(500) (because no dividends were declared during the period). Because the participating restricted stock units do not participate in the losses of the entity, all of the income (loss) for each respective line item is allocated to the common shareholders.

Diluted EPS is calculated using the more dilutive of the two-class method or the treasury stock method (because the outstanding securities are restricted stock units). Because there are no other potentially dilutive securities outstanding (other than the restricted stock units described above), the two-class method yields the same diluted EPS amount as basic EPS. Therefore, diluted EPS is computed using the treasury stock method. Additionally, because ASC 260-10-45-18 indicates that an entity that reports a discontinued operation should use income from continuing operations as the "control number" in determining whether potential common shares are dilutive, the restricted stock units are included in the diluted EPS calculation, even though it results in a lower diluted net loss per share compared to the basic net loss per share.

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(a) Calculated as $1,000 income from continuing operations ÷ 1,164 common shares. Incremental shares from assumed conversion of the restricted stock units are calculated as follows:

Assumed proceeds:
  Average unrecognized compensation $ 180
Shares repurchased:
  $180 / $5 average price per share = 36 shares
Incremental shares:
  200 restricted stock units − 36 shares repurchased = 164 shares

(b) Calculated as $1,500 loss from discontinued operations ÷ 1,164 common shares.

**Illustration 5-7: Application of the two-class method in a period of net income when an entity reports discontinued operations**

Assume the following for an entity:

- Loss from continuing operations of $1,000
- Income from discontinued operations of $1,500
- Common shares outstanding during the period of 1,000
- Participating restricted stock units outstanding during the period of 200 that participate in dividends with common shareholders on a 1:1 basis. The participating securities do not participate in losses of the entity.
- No dividends declared during the period

Basic and diluted EPS for the common shareholders would be calculated as follows:

| | | Basic EPS | Diluted EPS |
|---|---|---|---|
| Loss from continuing operations | $ (1,000) | $ (0.83) | $ (0.83) |
| Income from discontinued operations | 1,500 | 1.25 | 1.25 |
| Net income | $ 500 | $ 0.42 | $ 0.42 |

In this example, the benchmark for whether income (losses) will be allocated to participating securities is the undistributed net income of $500 (because no dividends were declared during the period). Because the participating securities participate in the income of the entity on a 1:1 basis with common shareholders, the income (loss) for each respective line item is allocated to both the common shareholders and the participating securities. Note that this results in the common shareholders being allocated income (loss) at a proportion of 1,000 / 1,200.

For the calculation of diluted EPS, there is a loss from continuing operations (the "control number" when determining whether the effect of securities is dilutive). Because the potentially dilutive shares in this example do not have a numerator adjustment, the potentially dilutive shares are antidilutive (see sections 4.9 (before the adoption of ASU 2020-06) and 4.9A (after the adoption of ASU 2020-06)). Therefore, diluted EPS is the same as basic EPS.

In the event that dividends were declared in a period in either of the above illustrations, the declared dividends would be subtracted from the net income (loss) amounts to arrive at undistributed net income (loss), which would be used to determine if the income (loss) should be allocated to participating securities. Additionally, we generally believe that any distributed income per share should be included in the income (loss) from continuing operations line item. The following example illustrates this guidance:

**Illustration 5-8: Determining when to allocate undistributed net income (loss) to participating securities**

Assume the following for an entity:

- Income from continuing operations of $1,000
- Loss from discontinued operations of $1,500
- Common shares outstanding during the period of 1,000 with an average price of $5 per share
- Participating restricted stock units outstanding during the period of 200 that participate in dividends with common shareholders on a 1:1 basis. The participating securities do not participate in losses of the entity.
- Average unrecognized compensation of $180 related to the restricted stock units
- Dividends declared on common shares of $200 and participating restricted stock units of $40

Basic and diluted EPS for the common shareholders would be calculated as follows:

| | | Basic EPS | | Diluted EPS | |
|---|---|---|---|---|---|
| Income from continuing operations | $ 1,000 | $ 0.96 | (a) | $ 0.86 | (d) |
| Loss from discontinued operations | (1,500) | (1.50) | (b) | (1.29) | (e) |
| Net loss | $ (500) | $ (0.54) | (c) | $ (0.43) | (f) |

In this example, the entity has an undistributed net loss of $(740) (which considers the effect of dividends declared during the period) and therefore none of the undistributed income (loss) will be allocated to the participating restricted stock units.

Diluted EPS is calculated using the more dilutive of the two-class method or the treasury stock method (because the outstanding securities are restricted stock units). As there are no other potentially dilutive securities outstanding (other than the restricted stock units described above), the two-class method would yield the same diluted EPS amount as basic EPS. Therefore, diluted EPS is computed using the treasury stock method.

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(a) Includes $0.20 distributed earnings per share ($200 dividends distributed to common shareholders ÷ 1,000 common shares) and $0.76 undistributed earnings per share ($1,000 income from continuing operations − $240 total dividends distributed during the period ÷ 1,000 common shares).

(b) Calculated as $1,500 loss from discontinued operations ÷ 1,000 common shares.

(c) Calculated as (($500) net loss − $40 dividends distributed to restricted stock unit holders during the period) ÷ 1,000 common shares.

(d) Comprises ($200 dividends distributed to common shareholders + $800 undistributed earnings (calculated as $1,000 income from continuing operations − $200 total dividends distributed during the period)) ÷ 1,164 common shares. Incremental shares from assumed conversion of the restricted stock units:

Assumed proceeds:

Average unrecognized compensation $ 180

Shares repurchased:

$180 / $5 average price per share = 36 shares

Incremental shares:

200 restricted stock units − 36 shares repurchased = 164 shares

(e) Calculated as $1,500 loss from discontinued operations ÷ 1,164 common shares.

(f) Calculated as $500 net loss ÷ 1,164 common shares.

## 5.3.6 Dividend equivalents paid on participating liability instruments

Certain liability instruments may be deemed participating securities. In those instances, careful consideration should be given to whether dividends declared on those participating securities are recorded in the income statement as expense (e.g., interest expense, compensation expense). If dividends are expensed, we believe that net income (loss) should not be adjusted for these dividends a second time in the earnings allocation process in applying the two-class method of computing EPS.

### 5.3.6.1 Dividend equivalents paid on participating share-based liabilities

Certain share-based payment awards classified as liabilities may be deemed participating securities. We believe that dividends declared on such awards should be recorded in the income statement as compensation cost (see section 3.6.2 of our FRD, ***Share-based payment***). Therefore, we believe that similar to dividends on awards not expected to vest (see section 5.4.1), net income (loss) should not be adjusted for dividends declared on participating share-based liabilities a second time in the earnings allocation process in applying the two-class method of computing EPS.

## 5.3.7 Quarterly and year-to-date calculations

For a year-to-date or annual period, we believe that the application of the two-class method of computing EPS should be made without regard to the quarterly computations. That is, income (loss) for the year-to-date or annual period should be allocated to participating securities independent of the quarterly EPS calculations. Additionally, we believe that the approach followed for computing diluted EPS (see section 5.3.3) should be made independently for each quarter and year-to-date period.

## 5.3.8 Tracking stocks

A tracking stock or targeted stock is a class of shares referenced to a specific business activity of an entity. An entity may issue multiple tracking stocks with each one tied to a different business activity. Typically, earnings available for dividends to that class are based, in part, on a measure of the performance of a subsidiary, segment, division or other defined unit of the issuer (herein referred to as the "Tracking Group").

Generally, the issuance of tracking stock results in the creation of two classes of common stock of the consolidated entity. One class is a newly created tracking stock that is intended to track the performance of the Tracking Group. The other class is the pre-existing common stock that is intended to track the performance of all other business activities of the entity, excluding the Tracking Group, but including the retained interest, if any, in the Tracking Group (herein referred to as the "Residual Group"). It is important to note that holders of each class of stock are shareholders of the consolidated entity and are subject to all of the risks associated with an investment in the consolidated entity.

Registrants do not present EPS amounts for the tracking stock for financial statements for periods prior to the tracking stock transaction because the related tracking stocks are not part of the capital structure during those periods. Subsequent to the issuance of tracking stock, EPS should be calculated separately for the Residual Group and for the Tracking Group using the two-class method provided by ASC 260.

Under the two-class method, EPS is determined for the Residual Group and the Tracking Group based on the separate earnings attributed to each Group's financial statements, which represents actual distributions to the respective classes of stock and undistributed earnings available for the payment of dividends on the respective classes of stock. The consolidated financial statements present the EPS for each class of tracking stock. For the period that includes the tracking stock issuance, EPS is presented for the entity's single stock up to the date of issuance of tracking stock and for the Tracking Group stock and Residual Group stock for the period such stocks were outstanding. EPS of one class of stock should not be presented alone or within the separate financial statements of the referenced business because those businesses did not issue the security.

Pro forma disclosure of the EPS for the Tracking Group and Residual Group stocks as if they had been outstanding for the entire period may be presented in either the proxy statement, which is used to obtain shareholder approval for the issuance of tracking stock, or the registration statement where tracking stock shares are first registered for issuance. Subsequent to the issuance of tracking stock, pro forma EPS giving effect to the issuance of tracking stock as of an earlier date should not be presented.

## 5.4 Participating securities in the form of share-based payments

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Participating Securities and the Two-Class Method*

*260-10-45-61*

Fully vested share-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.

*260-10-45-61A*

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.

*260-10-45-68B*

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.

As discussed in ASC 260-10-45-61A and 45-68B, nonvested share-based payment awards with a right to receive nonforfeitable dividends are participating securities. Case D of Example 9 in ASC 260 (see Appendix E) provides guidance on how to allocate earnings to participating share-based payment awards and compute basic EPS using the two-class method.

The sections that follow provide application guidance for the two-class method as it specifically relates to share-based payment awards.

### 5.4.1 Share-based payment — allocation of earnings and losses

The allocation of earnings to participating share-based payment awards generally is consistent with the base framework in ASC 260. However, because of certain issues that result from the accounting for nonforfeitable dividends paid to the holders of share-based payment awards pursuant to ASC 718, ASC 260 also includes allocation guidance to address these issues. ASC 718-10-55-45 states that nonrefundable dividends paid on awards that (1) are not expected to (or do not) vest if an entity elects to estimate forfeitures or (2) are forfeited if an entity elects to account for forfeitures as they occur are recognized as additional compensation cost. Accordingly, ASC 260-10-45-68B states that dividends recognized in earnings as compensation cost should not be included in the allocation of earnings when computing EPS because to do so would result in these dividends being subtracted from earnings available to common shareholders twice.

Therefore, if an entity elects to estimate forfeitures, the amount of distributed earnings allocated to the nonvested share-based payment awards should be the total dividends distributed to all share-based payment awards less dividends transferred to awards that are expected to be forfeited. If an entity elects to account for forfeitures as they occur, the amount of distributed earnings allocated to the nonvested share-based payment awards should be the total dividends distributed to all share-based payment awards less dividends transferred to date on awards that were forfeited during the period (i.e., the amount reclassified to compensation cost as discussed in section 3.6.1 of our FRD, ***Share-based payment***).

However, ASC 260-10-45-68B requires that *undistributed* earnings be allocated to *all* outstanding share-based payment awards (including those that are expected to be forfeited if an entity elects to estimate forfeitures). This approach is necessary because, under the two-class method, an entity assumes that it distributes all of its earnings for the period. If an entity distributed all of its earnings, it would be required to distribute earnings to the holders of all outstanding participating awards, which would reduce the earnings available to distribute to common shareholders.

Generally, undistributed losses (resulting from either a net loss or distributed income in excess of net income) would not be allocated to share-based payment awards because those awards generally do not have a contractual obligation to share in the losses of the issuing entity as discussed in ASC 260-10-45-67 and 45-68. See section 5.3.2 for further discussion of allocating losses to participating securities under the two-class method.

### 5.4.2 Earnings per nonvested share-based payment award

The requirement in ASC 260 to reduce distributed earnings to nonvested participating award holders by the amount of dividends transferred that were also recognized as additional compensation cost will result in a distributed EPS amount for nonvested participating awards that does not equal the declared dividend per-share amount (unless no forfeitures are expected or actually occur). In addition, when nonvested participating awards participate equally with common shares, the calculated basic EPS amount for the nonvested participating awards will be different than the calculated basic EPS amount for common shares (unless no forfeitures are expected or actually occur). These differences will occur because of the computational guidance included in ASC 260 regarding awards not expected to vest.

Under the provisions of ASC 260, basic and diluted EPS are required to be disclosed only for common stock. Because nonvested participating awards are not considered a class of common stock before the vesting or exercise of the awards, companies are not required to disclose EPS for these awards. However, the presentation of EPS for participating securities is not precluded. If a company decides to disclose the EPS amounts for its nonvested participating awards, we encourage them to include additional disclosures in their financial statements to mitigate the potential for any confusion on the part of the holders of the nonvested participating share-based awards that may result from the fact that EPS for their awards will differ from EPS for common stock. For example, entities may consider reconciling EPS amounts for nonvested participating share-based payment awards to earnings per common share by reference to the dividends recognized as

compensation cost. In practice, most companies do not include separate disclosure of EPS for nonvested participating share-based payments. We believe it would be more meaningful to simply exclude a separate disclosure of EPS for nonvested participating share-based payments since the holders of such awards participate on the same basis as common shareholders and can look to reported EPS for common stock.

### 5.4.3 Changes in forfeiture rates

For companies that estimate forfeitures, ASC 260-10-45-68B states that the estimated number of awards expected to be forfeited used in the two-class calculation should be consistent with the estimate made under ASC 718 for the purpose of determining compensation cost. In addition, consistent with the guidance in ASC 718, ASC 260 requires that any changes in the estimated number of forfeitures be reflected in the EPS calculation in the period that a change in estimate occurs. Therefore, the change in estimated forfeitures will only affect net income and EPS in the period a change in estimate occurs and will not affect EPS reported for prior periods (i.e., EPS in prior periods is not restated for changes in estimates of expected forfeitures). ASC 260 includes an example (Case D of Example 9, see Appendix E) that illustrates how a change in the forfeiture rate affects the computation of basic EPS using the two-class method.

### 5.4.4 Illustrative example

ASC 260 does not contain specific guidance on calculating diluted EPS using the treasury stock method and the if-converted method for participating securities that are also potential common shares. This illustrative example demonstrates one acceptable application.

**Illustration 5-9: Using the more dilutive of the two-class method and if-converted or treasury stock methods**

Entity A had 50,000 shares of common stock outstanding during 20X9 and net income of $150,000. On 1 January 20X9, Entity A granted 5,000 shares of nonvested stock to employees, each with a grant-date fair value of $40. These shares will vest at the end of five years (i.e., cliff vest). Entity A's accounting policy is to estimate forfeitures, and as of 1 January 20X9, Entity A estimated that 250 shares would not vest. During 20X9, no shares were actually forfeited, and the estimated forfeiture rate was not revised. The nonvested shareholders have a nonforfeitable right to participate in dividends with common shareholders on a dollar-for-dollar basis.

On 1 January 20X9, Entity A also granted options to employees to purchase 8,000 shares of common stock at the then-current market price of $40. The options have a grant-date fair value of $5 and vest at the end of five years (cliff vest). The option holders do not have rights to participate in dividends with the common shareholders. For ease of illustration, assume Entity A expects all of the options to vest.

On 31 December 20X9, Entity A declares and pays a $1 per share dividend (or dividends of $50,000 and $5,000 paid to the common shareholders and holders of nonvested shares, respectively). The average market price of Entity A's common stock for the year was $50 per share.

Basic EPS under the two-class method for the year ended 31 December 20X9, would be computed as follows:

| | | |
|---|---|---|
| Net income | | $ 150,000 |
| Less dividends to: | | |
| Common shares | $ 50,000 | |
| Nonvested shares | 4,750 (a) | |
| | | 54,750 |
| Undistributed 20X9 earnings | | $ 95,250 |

Allocation of undistributed net income:[b]

*To common shares:*

50,000 shares ÷ (5,000 shares + 50,000 shares) × $95,250 = $86,591

$86,591 ÷ 50,000 shares = $1.73 per share

*To nonvested shares:*

5,000 shares ÷ (5,000 shares + 50,000 shares) × $95,250 = $8,659

$8,659 ÷ 5,000 shares = $1.73 per share

(a) Amount represents the dividends paid to the holders of nonvested share-based payment awards that are expected to vest (5,000 nonvested shares — 250 nonvested shares expected to be forfeited) x $1 dividend per share = $4,750. Since the dividends paid on awards that are not expected to vest are already recognized as compensation cost, these dividends are not deducted from net income to calculate undistributed earnings.

(b) The shares used to determine the allocation of undistributed net income and per-share amounts are the weighted average common and nonvested shares (i.e., with no adjustment for estimated forfeitures) outstanding for the reporting period.

Basic EPS amounts:

| | Common shares | | Nonvested shares | |
|---|---|---|---|---|
| Distributed earnings | $ 1.00 | (c) | $ 0.95 | (d) |
| Undistributed earnings | 1.73 | | 1.73 | |
| Total | $ 2.73 | | $ 2.68 | |

(c) $50,000 of earnings distributed to common shareholders ÷ 50,000 weighted average common shares outstanding.

(d) $4,750 of earnings distributed to nonvested shareholders ÷ 5,000 weighted average nonvested shares outstanding.

Diluted EPS under both the treasury stock method and the two-class method for the year ended 31 December 20X9, would be computed as follows:

**Step 1 — Antidilution sequencing**[e]

| | Increase in earnings available to common shareholders | Increase in number of common shares | | Earnings per incremental share |
|---|---|---|---|---|
| Nonvested shares | $ - | 1,400 | (f) | $ - |
| Options | $ - | 880 | (g) | $ - |

(e) In this example, antidilution sequencing is not relevant as the options and nonvested shares have the same earnings per incremental share.

(f) Incremental shares outstanding from assumed vesting of the outstanding nonvested shares:

| Calculation of assumed proceeds: | |
|---|---|
| Average unrecognized compensation cost: | ($200,000 + $160,000) ÷ 2 = $180,000 |
| Shares repurchased: | $180,000 ÷ $50 = 3,600 shares |
| Incremental shares: | 5,000 − 3,600 = 1,400 shares |

(g) Incremental shares outstanding from assumed exercise of the outstanding options:

| Calculation of assumed proceeds: | |
|---|---|
| Assumed proceeds received from the exercise of options | $40 x 8,000 = $320,000 |
| Average unrecognized compensation cost | ($40,000 + $32,000) ÷ 2 = $36,000 |
| Total assumed proceeds | $320,000 + 36,000 = $356,000 |
| Shares repurchased: | $356,000 ÷ $50 = 7,120 shares |
| Incremental shares: | 8,000 − 7,120 = 880 shares |

**Step 2 — Calculation of diluted EPS using the treasury stock method for the nonvested shares and options**

| | Undistributed & distributed earnings to common shareholders | Common shares | EPS |
|---|---|---|---|
| As reported — basic | $ 136,591 (h) | 50,000 | $ 2.73 |
| Earnings allocated to nonvested shares | 13,409 (i) | | |
| Subtotal (j) | 150,000 | 50,000 | $ 3.00 |
| Nonvested shares | – | 1,400 | |
| Subtotal | 150,000 | 51,400 | $ 2.92 |
| Options | – | 880 | |
| Diluted EPS — common shares | $ 150,000 | 52,280 | $ 2.87 |

(h) Calculated as $50,000 dividend declared to common shareholders plus an additional $86,591 allocated to common shares.

(i) $4,750 of earnings distributed to nonvested shareholders + $8,659 of undistributed earnings allocated to nonvested shareholders.

(j) This is the control number for calculating diluted EPS. See ASC 260-10-45-20 in section 4.2.

**Step 3 — Calculation of diluted EPS using the two-class method**

| Common shares | Undistributed & distributed earnings to common shareholders | Common shares | EPS |
|---|---|---|---|
| As reported — basic | $ 136,591 | 50,000 | $ 2.73 |
| Add-back: | | | |
| Undistributed earnings allocated to nonvested shareholders | 8,659 (k) | - | |
| Options | - | 880 | |
| Less: | | | |
| Undistributed earnings reallocated to nonvested shareholders | (8,523) (l) | - | |
| Diluted EPS — common shares | $ 136,727 | 50,880 | $ 2.69 |

(k) See computation of undistributed net income allocated to nonvested shares.

(l) (5,000 ÷ (5,000 + 50,000 + 880)) × $95,250 undistributed earnings = $8,523.

| Nonvested shares | Undistributed & distributed earnings to nonvested shareholders | Nonvested shares | EPS |
|---|---|---|---|
| As reported — basic | $ 13,409 | 5,000 | $ 2.68 |
| Less: | | | |
| Undistributed earnings allocated to nonvested shareholders | (8,659) | - | |
| Add-back: | | | |
| Undistributed earnings reallocated to nonvested shareholders | 8,523 | - | |
| **Diluted EPS — nonvested shares** | $ 13,273 | 5,000 | $ 2.65 |

In this example, Entity A is required to disclose diluted EPS per common share of $2.69 using the two-class method because using the treasury stock method results in a less dilutive EPS amount of $2.87. Although the EPS amounts for nonvested shares are not required to be disclosed pursuant to the disclosure requirement in ASC 260, Entity A is not precluded from doing so. If Entity A decides to disclose EPS amounts for its nonvested shares, it will disclose $2.65 as the diluted EPS amount for the nonvested shares (see section 5.4.2 for a discussion on disclosing EPS for nonvested participating awards). The following table summarizes the basic and diluted EPS amounts for the common and nonvested shares:

| | **Common shares** | **Nonvested shares** |
|---|---|---|
| Basic | $ 2.73 | $ 2.68 |
| Diluted | 2.69 | 2.65 |

Since some of the dividends paid to the nonvested shares are excluded from the EPS calculation, the result is a lower EPS figure for nonvested shares compared to that for common shares (i.e., $2.68 basic EPS for nonvested shares versus $2.73 basic EPS for common shares). This result is somewhat misleading since the nonvested shares are entitled to the same dividends as common shares (in this illustration, the nonvested shares participate on a one-for-one basis). This difference arises because the dividends paid to nonvested shares that are expected to be forfeited are already included as compensation cost and, therefore, are not considered in the earnings allocation. Because of the confusion that may arise from this treatment, we do not recommend that companies separately present EPS for nonvested shares and other share-based payments, but companies are not precluded from doing so.

## 5.5 Master limited partnerships

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Overview and Background*

*Master Limited Partnerships*

*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.

*260-10-05-3*

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.

*260-10-05-4*

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.

*260-10-05-5*

Paragraphs 260-10-45-59A through 45–70 address the use of the two-class method to calculate earnings per unit for capital structures that are not convertible into a class of common stock.

*Scope and Scope Exceptions*

*Master Limited Partnerships*

*260-10-15-4*

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.

*260-10-15-5*

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.

Publicly traded master limited partnerships (MLPs) typically issue multiple classes of securities that participate in partnership distributions according to a formula specified in the partnership agreement.

A typical MLP consists of publicly-traded common units (and in some cases, subordinated common units) held by limited partners (LPs), a general partner (GP) interest and incentive distribution rights (IDRs). IDRs may be a separate class of non-voting limited partner interest that the GP initially holds, but may be transferable apart from its GP interest. IDRs also may be embedded in the GP interest (in other words, they cannot be transferred separately from the GP's overall interest in the MLP).

In many cases, the partnership agreement requires the GP to distribute 100% of the partnership's "Available Cash" to the LPs, GP and, when certain thresholds are met, to the holder(s) of IDRs based on a distribution waterfall schedule included in the partnership agreement. Partnership agreements generally state that the holder(s) of IDRs are not entitled to distributions other than those provided in the distribution waterfall of Available Cash. The net income (or loss) of the partnership is allocated to the capital accounts of the GP and LPs based on their ownership percentages after taking into account any priority income allocations (or distributions) to the holder(s) of IDRs. Illustration 5-11 in section 5.5.5 depicts the concepts discussed in this section.

## 5.5.1 Determining whether an IDR is a participating security

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Master Limited Partnerships*

*Incentive Distribution Rights That Are a Separate Class of Limited Partner Interest*

*260-10-45-72*

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.

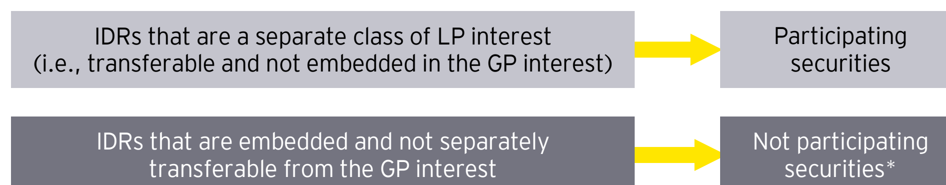
*Incentive Distribution Rights That Are Embedded in the General Partner Interest*

*260-10-45-73*

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.

IDRs in an MLP that are a separate class of LP interest (i.e., the IDRs are transferable and not embedded in the GP interest) are participating securities. If the IDRs are embedded and not separately transferable from the GP interest, the IDRs themselves are not participating securities. However, the GP interest and the embedded IDRs are a participating security. Because the GP and LPs both participate in the distribution of earnings, MLPs are required to calculate earnings per unit (EPU) using the two-class method.

The graphic below summarizes the guidance in ASC 260-10-45-72 and 45-73:




* While the IDRs themselves are not participating securities, the GP interest and the embedded IDR together are participating securities because they are a separate class of equity from the LP interests.

## 5.5.2 Allocation of earnings and losses

### 5.5.2.1 IDR is separately transferable

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Master Limited Partnerships*

*Incentive Distribution Rights That Are a Separate Class of Limited Partner Interest*

*Distributions*

*260-10-55-103*

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*

*260-10-55-104*

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.

*260-10-55-105*

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*

*260-10-55-106*

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.

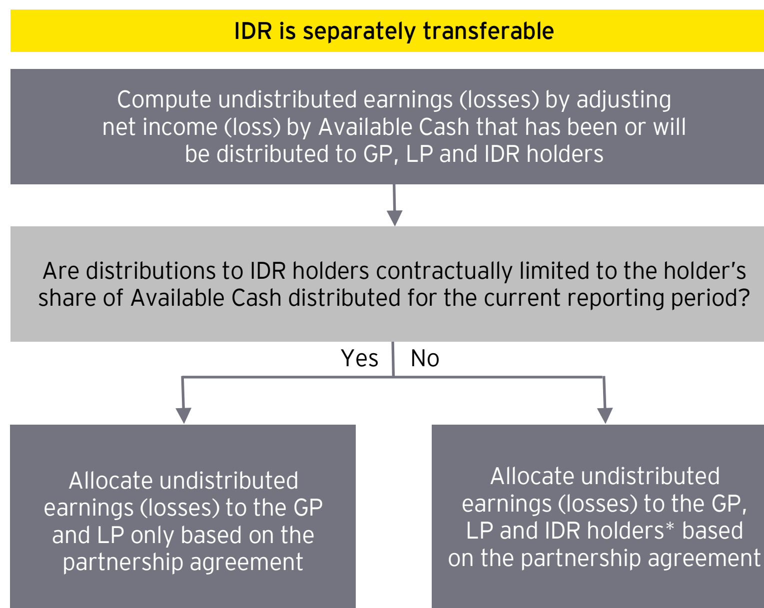
If IDRs are separately transferable, earnings or losses for a reporting period should be allocated to the GP, LPs and the holder(s) of IDRs (collectively referred to hereafter in this section as "the participating security holders") using the two-class method to compute EPU. When computing EPU under the two-class method, ASC 260-10-55-103 requires net income (loss) for a reporting period to be reduced (or increased) by the amount of Available Cash that has been or will be distributed to the participating security holders for that reporting period. Because partnership agreements generally obligate the GP to distribute Available Cash for each reporting period within a certain number of days after the end of a reporting period (e.g., 60 days), the GP will need to determine Available Cash to be distributed to the participating security holders prior to issuing financial statements for each reporting period.

After adjusting net income for the reporting period by the amounts distributed to the participating security holders, any undistributed earnings should be allocated to the participating security holders, including the holder(s) of IDRs, pursuant to the terms of the partnership arrangement. Thus, if the partnership arrangement contractually limits the amount of distributions to the holder(s) of IDRs, undistributed earnings should not be allocated to the holder(s) of IDRs in excess of the specified amount.

To determine whether distributions to the holder(s) of IDRs are limited contractually, an MLP will need to evaluate whether distributions to the IDRs for a reporting period would be limited to Available Cash even if all earnings for the period were distributed (e.g., in the event of a liquidating dividend). Typically, partnership agreements specify that distributions to the holder(s) of IDRs for a reporting period contractually are limited to the holder's share of Available Cash distributed for the current reporting period. In this case, all undistributed earnings or losses would be allocated to the GP and LPs, and no undistributed earnings or losses would be allocated to the holder(s) of IDRs. However, if the partnership agreement is silent or does not explicitly limit distributions to the holder(s) of IDRs, the MLP should allocate undistributed earnings or losses to the participating security holders using the distribution waterfall schedule (or other distribution methodology) specified in the partnership agreement.

When distributions to the participating security holders exceed earnings for the reporting period, net income (loss) would be reduced (increased) by actual distributions. The resulting net undistributed loss should be allocated to the GP and LPs based on the method of allocating losses specified in the partnership agreement. Losses should be allocated to the holder(s) of IDRs only to the extent they are contractually obligated to participate in losses.

This guidance is summarized in the flowchart below:




* Allocate losses to IDR holders only if contractually obligated to share in losses

### 5.5.2.2 IDR is not separately transferable

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Master Limited Partnerships*

*Incentive Distribution Rights That Are Embedded in the General Partner Interest*

*Distributions*

*260-10-55-107*

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*

*260-10-55-108*

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.

*260-10-55-109*

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.

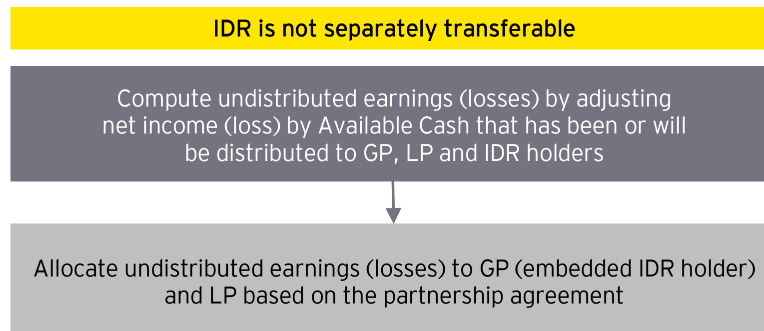
*Cash Distributions in Excess of Earnings*

*260-10-55-110*

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.

IDRs that are embedded and not separately transferable from the GP interest are not separate participating securities. While this type of IDR is not considered a separate participating security, MLPs are still required to compute EPU under the two-class method because the GP and LP interests are separate classes of equity. When the IDRs are embedded in the GP interest, the guidance in ASC 260 is virtually the same as when the IDRs are a separate LP interest, except that all distributions and allocations of undistributed earnings (losses) related to the IDRs are aggregated with the distributions and allocations of earnings (losses) to the GP interest. As a result, the effect on the calculated EPU for the LP interests would be the same regardless of whether the IDRs are a separate LP interest or are embedded in the GP interest. However, the calculated EPU for the GP, in many cases, will be higher than if the IDRs were considered separate participating securities.

This guidance is summarized in the flowchart below:




### 5.5.2.3 Allocation of earnings and losses prior to a dropdown

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

*Dropdown*

A transfer of certain net assets from a sponsor or general partner to a master limited partnership in exchange for consideration.

*Disclosure*

*Master Limited Partnerships*

*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.

*Implementation Guidance and Illustrations*

*Restatement of EPS Data*

*Prior-Period Adjustments*

*260-10-55-16A*

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.

*Master Limited Partnerships*

*Presentation of Historical Earnings per Unit after a Dropdown Transaction Accounted for as a Transaction between Entities under Common Control*

*260-10-55-111*

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.

When an existing MLP receives net assets in a dropdown transaction that is accounted for as a transaction between entities under common control in accordance with ASC 805-50, for purposes of calculating historical EPU under the two-class method, the earnings (losses) of transferred net assets before the date of a dropdown transaction should be allocated entirely to the GP interest. In that circumstance, the previously reported EPU of the LP would not change as a result of the dropdown transaction. Qualitative disclosures about how the rights to the earnings (losses) differ before and after the dropdown transaction occurs for purposes of computing EPU under the two-class method also are required. The following example illustrates the interplay of accounting for a transaction between entities under common control and the EPU allocation set forth in the standard:

**Illustration 5-10: EPS calculations when there is a transaction between entities under common control**

On 1 January 20x6, GP ABC, the sponsor of MLP XYZ, transferred certain net assets to MLP XYZ in exchange for cash as part of a dropdown transaction between entities under common control. GP ABC has controlled MLP XYZ for the past 10 years. According to the partnership agreement, net income (loss) is allocated to the GP and LPs based on their ownership percentages (2% and 98%, respectively). There are no other equity interests outstanding at MLP XYZ other than the GP and LPs and no potential outstanding units. The following is MLP XYZ's originally reported EPU for 20X5 and 20X4:

| | 20X5 | 20X4 |
|---|---|---|
| Net income attributable to partnership | $ 10,000 | $ 10,000 |
| Income attributable to general partner | $ 200 | $ 200 |
| Income attributable to limited partners | $ 9,800 | $ 9,800 |
| Weighted average LP units outstanding | 9,800 | 9,800 |
| Weighted average GP units outstanding | 200 | 200 |
| Basic and Diluted EPU — LPs | $ 1.00 | $ 1.00 |
| Basic and Diluted EPU — GP | $ 1.00 | $ 1.00 |

In the first periodic report subsequent to the 1 January 20X6 dropdown, MLP XYZ is required to retrospectively adjust its income statements as of the opening balance sheet date of the earliest year presented because control, in this example, was obtained prior to the opening balance sheet date of the earliest period presented. Assume that net income related to the transferred assets was $1,000 in 20X5 and 20X4, respectively. The following table illustrates how the retrospectively adjusted net income of $11,000 would be allocated in the calculation of EPU for 20X5 and 20X4. The previously reported earnings per unit of the limited partners for 20X5 and 20X4 of $1.00 should not change. EPU should not change as a result of the dropdown transaction for periods prior to the date of the dropdown transaction, which in this case is 1 January 20X6. In order to achieve this result, $1,200 of the $11,000 in retrospectively adjusted income must be allocated to the general partner. The remaining $9,800 represents the amount that was originally allocated to the limited partners, which should not change. The calculation is illustrated below.

| | 20X5 | 20X4 |
|---|---|---|
| Originally reported net income attributable to partnership | $ 10,000 | $ 10,000 |
| Net income of transferred assets | $ 1,000 | $ 1,000 |
| Retrospectively adjusted net income | $ 11,000 | $ 11,000 |
| Income attributable to general partner | $ 1,200 (a) | $ 1,200 (b) |
| Income attributable to limited partners | $ 9,800 | $ 9,800 |
| Weighted average LP units outstanding | 9,800 | 9,800 |
| Weighted average GP units outstanding | 200 | 200 |
| Basic and Diluted EPU — LPs | $ 1.00 | $ 1.00 |
| Basic and Diluted EPU — GP | $ 6.00 | $ 6.00 |

(a) Calculated based on the original $200 of income allocated to the general partner + $1,000 of income allocated to the general partner related to the transferred assets.

(b) Calculated based on the original $200 of income allocated to the general partner + $1,000 of income allocated to the general partner related to the transferred assets.

MLP XYZ also would disclose that that the GP had rights to 100% of the income (loss) of the transferred assets prior to the date of the dropdown and that the GP and LPs had rights to 2% and 98%, respectively, of income (loss) subsequent to the dropdown for purposes of computing EPU under the two-class method.

### 5.5.3 Determination of Available Cash

The requirement to determine the contractual obligation to the holder(s) of IDRs at the end of a reporting period will require MLPs to determine Available Cash at the end of a reporting period before the financial statements for that period are issued. As such, this requirement may cause some MLPs to accelerate the timing of this determination in order to comply with the requirements of ASC 260. While ASC 260-10-55-103 and 55-107 (see sections 5.5.2.1 and 5.5.2.2, respectively) require entities to determine Available Cash prior to issuing their financial statements for purposes of calculating EPU, it does not require MLPs to record a distribution payable prior to distributions being declared. For example, if an MLP determines Available Cash for the first quarter of their calendar year 20X0 reporting period in April 20X0, the MLP would not record a distribution payable until April 20X0 when the distribution actually is declared, even though the distributions will be used to compute EPU for the first quarter reporting period.

### 5.5.4 Quarterly and year-to-date calculations

We believe, based on discussions with the FASB staff, that the computation of EPU for a year-to-date or an annual period should be made without regard to the quarterly computations. That is, earnings for the annual period should be allocated to the unit classes independent of the quarterly EPU calculations.

### 5.5.5 Example of an EPU calculation for an MLP

The following example illustrates the concepts and computational guidance in ASC 260 to calculate EPU for an MLP. This example does not include a calculation of diluted EPU because many MLPs do not have additional dilutive securities outstanding. If additional dilutive securities were outstanding, the concepts discussed in section 5.3.3 and illustrated in the diluted EPS calculation included in section 5.4 would be followed.

Additionally, in the context of a partnership, we believe that to the extent ownership units do not have a preference on liquidation, these securities would be equivalent to common stock. As a result, EPU for these securities is required to be reported in the financial statements of a partnership. Disclosure of EPU for other participating securities is not precluded. In many MLP structures, the IDRs are not denominated in units. As a result, we have not included presentation of EPU for IDRs in the illustration below.

**Illustration 5-11: EPU calculation for an MLP**

During the first and second quarters of 20X9, Partnership XYZ has 9,800 Common Units outstanding held by the LPs, 200 GP units outstanding held by the GP and IDRs outstanding also held by the GP. According to the partnership agreement, net income (loss) is allocated to the GP and LPs based on their ownership percentages (2% and 98%, respectively) after giving effect to any priority income allocations to the IDR holder. The partnership agreement states that distributions to the holders of IDRs are limited to the holder's share of Available Cash distributed for the current reporting period.

The IDRs are held by the GP and represent a separate class of non-voting limited partnership interests that are transferable by the GP separate from its ownership interest. The GP is obligated to distribute 100% of the partnership's Available Cash every quarter based on a distribution waterfall specified in the partnership agreement. The GP must distribute the Available Cash within 60 days after the end of the quarter. The MLP must determine the Available Cash to be distributed prior to issuing its quarterly financial statements. The distributions to the IDRs contractually are limited to the eligible amounts as stipulated in the waterfall schedule, and the IDRs contractually are not obligated to participate in losses. During the first and second quarter of 20X9, the partnership had Available Cash of $25,000 each quarter (fully distributed to the GP, LPs and IDR holder) and net income of $50,000 and $15,000, respectively. The following table illustrates the cumulative amount of Available Cash that would be distributed to the Common Units, GP interest and IDRs at each of the thresholds based on the distribution waterfall in the partnership agreement:

| | | Waterfall percentage | | | *Cumulative* distribution by interest | | | |
|---|---|---|---|---|---|---|---|---|
| | Distribution per common units (LPs) | LPs | GP | IDRs | LPs | GP | IDRs | Total |
| 1st threshold | $ 0.40 | 98% | 2% | –% | $ 3,920 | $ 80 | $ – | $ 4,000 |
| 2nd threshold | 0.50 | 85% | 2% | 13% | 4,900 | 103 | 150 | 5,153 |
| 3rd threshold | 0.60 | 75% | 2% | 23% | 5,880 | 129 | 451 | 6,460 |
| Thereafter | N/A | 50% | 2% | 48% | | | | |

The following represents the basic EPU calculations for first quarter, second quarter and year-to-date period as of the end of the second quarter using the two-class method:

Basic EPU under the two-class method for the first quarter ended 31 March 20X9 would be computed as follows:

| | | |
|---|---|---|
| Net income | | $ 50,000 |
| Less distributions to: | | |
| Incentive distribution rights | $ 9,350 (a) | |
| General partner | 500 (b) | |
| Limited partners | 15,150 (c) | |
| | | 25,000 |
| Undistributed net income | | $ 25,000 |

Allocation of undistributed net income to the GP and LPs:[(d)]

To general partner:

2% ownership interest × $25,000 = $500

$500 ÷ 200 units = $2.50 per unit

To limited partners:

98% ownership interest × $25,000 = $24,500

$24,500 ÷ 9,800 units = $2.50 per unit

Basic EPU amounts:

| | General partner | Limited partners |
|---|---|---|
| Distributed earnings | $ 2.50 (e) | $ 1.55 (f) |
| Undistributed earnings | 2.50 | 2.50 |
| Total | $ 5.00 | $ 4.05 |

(a) $451 cumulative distribution to IDR holders for 3rd threshold + $8,899 [($25,000 (Available Cash) − $6,460 (total cumulative distribution for 3rd threshold)) x 48% waterfall percentage].

(b) $129 cumulative distribution to GP for 3rd threshold + $371 [($25,000 (Available Cash) − $6,460 (total cumulative distribution for 3rd threshold)) x 2% waterfall percentage].

(c) $5,880 cumulative distribution to LPs for 3rd threshold + $9,270 [($25,000 (Available Cash) − $6,460 (total cumulative distribution for 3rd threshold)) x 50% waterfall percentage].

(d) The units used to determine the undistributed net income per unit are the weighted average GP and LP units outstanding for the reporting period.

(e) $500 (earnings distributed to the GP) ÷ 200 weighted average GP units outstanding.

(f) $15,150 (earnings distributed to the LPs) ÷ 9,800 weighted average LPs outstanding.

Basic EPU under the two-class method for the second quarter ended 30 June 20X9, would be computed as follows:

| | | |
|---|---|---|
| Net income | | $ 15,000 |
| Less distributions to: | | |
| Incentive distribution rights | $ 9,350 (g) | |
| General partner | 500 (g) | |
| Limited partners | 15,150 (g) | |
| | | 25,000 |
| Undistributed net loss | | $ (10,000) |

Allocation of undistributed net loss to the GP and LPs:

To general partner:

2% ownership interest × $(10,000) = $(200)

$(200) ÷ 200 units = $(1.00) per unit

To limited partners:

98% ownership interest × $(10,000) = $(9,800)

$(9,800) ÷ 9,800 units = $(1.00) per unit

Basic EPU amounts:

| | General partner | Limited partners |
|---|---|---|
| Distributed earnings | $ 2.50 (g) | $ 1.55 (g) |
| Undistributed earnings | (1.00) | (1.00) |
| Total | $ 1.50 | $ 0.55 |

Basic EPU under the two-class method for the year-to-date period ended 30 June 20X9 would be computed as follows:

| | | |
|---|---|---|
| Net income | | $ 65,000 |
| Less distributions to: | | |
| Incentive distribution rights | $ 18,700 (h) | |
| General partner | 1,000 (i) | |
| Limited partners | 30,300 (j) | |
| | | 50,000 |
| Undistributed net income | | $ 15,000 |

(g) See computation under the two-class method for the first quarter ended 31 March 20X9.

(h) $9,350 (Q1 distribution) + $9,350 (Q2 distribution).

(i) $500 (Q1 distribution) + $500 (Q2 distribution).

(j) $15,150 (Q1 distribution) + $15,150 (Q2 distribution).

Allocation of undistributed net income to the GP and LPs:

To general partner:

2% ownership interest × $15,000 = $300

$300 ÷ 200 units = $1.50 per unit

To limited partners:

98% ownership interest x $15,000 = $14,700

$14,700 ÷ 9,800 units = $1.50 per unit

Basic EPU amounts:

| | **General partner** | **Limited partners** |
|---|---|---|
| Distributed earnings | $ 5.00 (k) | $ 3.09 (l) |
| Undistributed earnings | 1.50 | 1.50 |
| Total | $ 6.50 | $ 4.59 |

(k) $1,000 (year-to-date distributions) ÷ 200 weighted average GP units outstanding.

(l) $30,300 (year-to-date distributions) ÷ 9,800 weighted average LP units outstanding.

# 6 Other matters

## 6.1 Securities of subsidiaries

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Securities of Subsidiaries*

*260-10-55-20*

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.

*260-10-55-21*

The preceding provisions also apply to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

*260-10-55-22*

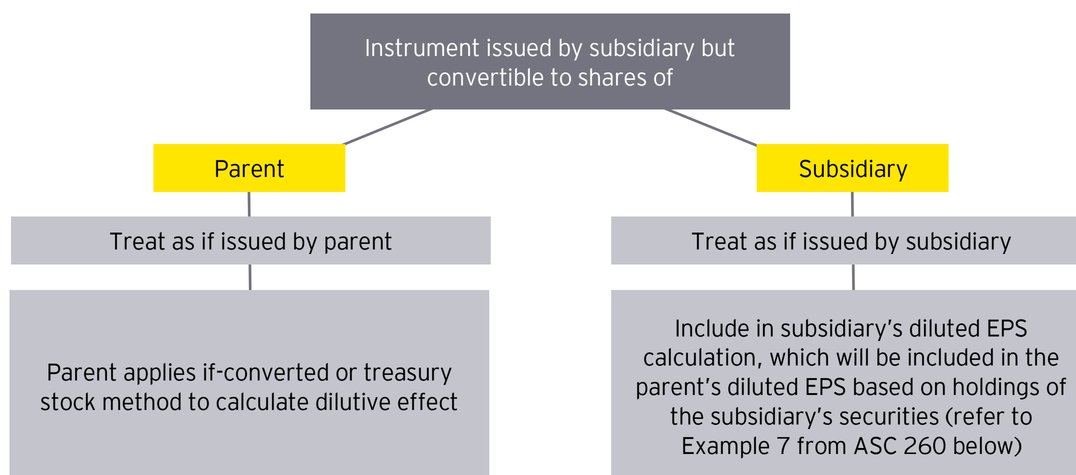
The if-converted method shall be used in determining the EPS impact of securities issued by a parent entity that are convertible into common stock of a subsidiary or an investee entity accounted for under the equity method. That is, the securities shall be assumed to be converted and the numerator (**income 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.

The effect on consolidated diluted 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 upon exercise or conversion. Such

securities generally do not affect basic EPS but may affect consolidated diluted EPS. If the instruments are exercisable or convertible into shares of the parent, the instrument is treated for EPS purposes as if issued by the parent and the parent would generally apply the treasury stock or if-converted method to calculate the dilutive effect. If the instruments are exercisable or convertible into shares of the subsidiary, the instrument is treated for EPS purposes as if issued by the subsidiary, and the resulting diluted EPS amount is used to calculate the parent's diluted EPS, as described in the illustration below.

Securities issued by a subsidiary that allow grantees to obtain the subsidiary's common stock (e.g., stock options) affect not only the subsidiary's diluted EPS (if it is a public company) but also that of its parent. Such securities generally do not affect basic EPS.

The flowchart below illustrates this guidance:




Other issues arise for debt or preferred stock issued by either the parent or the subsidiary that are convertible into the stock of the consolidated subsidiary. The if-converted method should be used in these instances. In this regard, ASC 260-10-55-22 notes that the numerator in diluted EPS computations must reflect the reduction in earnings that the parent would recognize by owning a smaller percentage of the subsidiary when the securities are assumed to be converted into additional stock of the subsidiary. The diluted EPS of the subsidiary is first calculated on a stand-alone basis (using the if-converted method) and then multiplied by the number of shares owned by the parent to determine the parent's share of the subsidiary's earnings.

The denominator of the consolidated diluted EPS computation would not be affected because the number of shares of the parent entity's common stock outstanding would not change after the potential exercise or conversion of a subsidiary's securities. Inclusion of a subsidiary's diluted EPS is used only when the effect is dilutive. Further, the above approach should also be applied in a similar manner to securities that are convertible into common stock of an equity method investee or unconsolidated joint venture.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 7: Securities of a Subsidiary — Computation of Basic and Diluted EPS*

*260-10-55-64*

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:

*260-10-55-65*

*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.

*260-10-55-66*

*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.

*260-10-55-67*

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] x 200

[f] Shares of subsidiary's common stock assumed outstanding from conversion of convertible preferred stock, computed: 200 convertible preferred shares x conversion factor of 2

[g] Parent's net income

[h] Portion of subsidiary's income to be included in consolidated basic EPS, computed: (900 x $3.30) + (100 x $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) x (1,000 shares x $2.40 per share)

[k] Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: (40 ÷ 200) x (100 incremental shares x $2.40 per share)

[l] Parent's proportionate interest in subsidiary's earnings attributable to convertible preferred stock, computed: (100 ÷ 200) x (400 shares from conversion x $2.40 per share)

## 6.2 Own-share lending arrangements issued in contemplation of convertible debt issuance or other financing

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance or Other Financing*

*260-10-45-70B*

Paragraph 470-20-45-2A provides guidance on calculating basic and diluted earnings per share if an entity has entered into own-share lending arrangements issued in contemplation of convertible debt issuance or other financing.

Debt — Debt with Conversion and Other Options

*Other Presentation Matters*

*Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance*

*470-20-45-2A*

Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs, at which time the loaned shares would be included in the basic and diluted earnings-per-share calculation. If dividends on the loaned shares are not reimbursed to the entity, any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares shall be deducted in computing income available to common shareholders, in a manner consistent with the two-class method in paragraph 260-10-45-60B.

As a result of market conditions and the need for financing, a number of entities for which the cost to an investment banking firm or third-party investors of borrowing their shares is prohibitive (e.g., due to a lack of liquidity or extensive open short positions in the shares) may enter into share-lending arrangements that are executed separately but in connection with a convertible debt offering. Although the convertible debt instrument ultimately is sold to investors, the share-lending arrangement is an agreement between the entity (i.e., share lender) and an investment bank (i.e., share borrower) and is intended to facilitate the ability of the investors to hedge the conversion option in the entity's convertible debt.

The share-lending arrangement generally is entered into with the investment bank underwriting the offering. The terms of the share-lending arrangement require the entity to issue shares (i.e., loaned shares) to the investment bank in exchange for a nominal loan processing fee. Although the loaned shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is significantly less than the fair value of the loaned shares or the share-lending arrangement.

Generally, upon maturity or conversion of the convertible debt, the investment bank is required to return the loaned shares to the entity for no additional consideration. That is, the share-lending arrangement requires physical settlement. Loaned shares that are issued by the entity subject to these share-lending arrangements legally are outstanding, and the holders of those shares are entitled to receive dividends and to vote on shareholder matters.

However, the terms of these share-lending arrangements often stipulate that over the period the shares are loaned to the investment bank (i.e., the loan period), the investment bank is required to (1) reimburse the entity for any dividends paid on the loaned shares, even if the investment bank has sold the loaned shares into the market, and (2) not vote on any matters submitted to a vote of the entity's shareholders if the investment bank is the owner of record. Although most share-lending arrangements do not require the investment bank to post collateral during the loan period, a collateral provision does sometimes exist.

The EITF addressed issues regarding how an issuer should account for a share-lending arrangement that is entered into in contemplation of a convertible debt offering and what effect, if any, the share-lending arrangement should have on the calculation of the issuer's EPS in EITF 09-1 (primarily codified in ASC 470-20). EITF 09-1 applied to equity-classified share-lending arrangements on an entity's own shares when executed in contemplation of a convertible debt offering or other financing.

With respect to EPS, the EITF decided that loaned shares under share-lending arrangements should be excluded from the computation of basic and diluted EPS, unless an actual default by the counterparty has occurred (i.e., the investment bank counterparty did not return the loaned shares to the issuer). This conclusion is consistent with the guidance on contingently issuable shares (as discussed in section 3.3.2), which says that shares that are contingently returnable should be excluded from the denominator in computing basic EPS, even if they have been issued. Many share-lending arrangements require the investment bank to reimburse the entity for any dividends paid on the loaned shares. If the investment bank does not reimburse the entity for these dividends, the dividends attributable to the loaned shares should be deducted when computing income available to common shareholders in a manner consistent with the two-class method. This is because the share-lending arrangement meets the definition of a participating security. See section 5 for further discussion of the two-class method. See section 5.5 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for further discussion of share-lending arrangements, including required disclosures.

## 6.3 Partially paid shares and partially paid stock subscriptions (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Partially Paid Shares and Partially Paid Stock Subscriptions*

*260-10-55-23*

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.

Stock subscriptions allow entities to offer employees and other investors the ability to purchase shares of the entity's common stock typically over a period of time and without a broker's commission. How partially paid shares and partially paid stock subscriptions affect basic and diluted EPS generally depends on whether the shares are entitled to dividends prior to being fully paid.

If partially paid shares are entitled to dividends in proportion to the amount paid, the common-share equivalent of those partially paid shares (e.g., a share fraction) should be included in the computation of basic EPS.

Partially paid stock subscriptions that do not share in dividends until fully paid (and the remainder of the unpaid common-share equivalent over and above the partially paid shares included in basic EPS, as described above) are considered the equivalent of warrants and should be included in diluted EPS under the treasury stock method. When the treasury stock method is applied, the unpaid balance is assumed to represent proceeds used to purchase stock, and the incremental number of shares to be included in the denominator is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

To the extent that the wholly unpaid or unpaid portion of a share or stock subscription has a right to participate in dividends, it is a participating security and the use of the two-class method for basic EPS is required (see section 5). The more dilutive of the treasury stock or two-class method is used to calculate diluted EPS.

See section 3.2.5.1 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, for further discussion of partially paid shares and stock subscriptions.

The following examples illustrate the guidance on participating and non-participating partially paid shares and stock subscriptions, respectively:

**Illustration 6-1: Participating partially paid shares**

Company A has 10,000 partially paid shares outstanding that participate in dividends based on the percentage of the purchase price paid. The purchase price for the shares is $20 each. On the first day of the quarter, the holder paid $5 per share and is required to pay $5 on the first of every subsequent month until the entire purchase price is paid. Assuming all payments are made timely during the initial quarter, the following illustrates the computation of the additional shares for that quarter for purposes of basic EPS computations (assume 30 days in each month of the quarter):

| | | |
|---:|---:|---|
| $5 / $20 x 10,000 shares x 30 days = | 75,000 | |
| $10 / $20 x 10,000 shares x 30 days = | 150,000 | |
| $15 / $20 x 10,000 shares x 30 days = | 225,000 | |
| | 450,000 | |
| ÷ 90 days | 5,000 | additional shares |

Additionally, for purposes of diluted EPS, the portion of the stock subscription that is unpaid during the period is treated similar to an outstanding warrant using the treasury stock method. In the above example, assume the average share price during the period is $22. The number of shares added to the calculation of diluted EPS would be as follows:

| | |
|---|---:|
| Shares underlying forward | 10,000 |
| Less shares included in basic EPS | 5,000 |
| Shares accounted for as an option or forward | 5,000 |
| Less shares repurchased with assumed proceeds (5,000 × $20 / $22) | 4,545 |
| Incremental shares added to diluted EPS calculation | 455 |

**Illustration 6-2: Non-participating partially paid stock subscriptions**

Employees of Company A have subscribed to purchase 500,000 shares of common stock at a price of $25 per share. The unpaid balance on the stock subscription amounts to $9 million, or $18 per share. Until fully paid, employees are not entitled to any dividends. The average market price of Company A's common stock was $32 for the period. The expected proceeds of $9 million would be assumed to be used to purchase 281,250 shares at the average market price for the period of $32. In the diluted EPS calculation, 218,750 incremental shares (500,000 shares subscribed less 281,250 shares assumed repurchased) would be included in the denominator.

## 6.4 Rabbi trusts

In some cases, employees are allowed to invest deferred compensation amounts in a "rabbi trust." A rabbi trust is a funding vehicle sometimes used to protect deferred executive compensation benefits from events other than bankruptcy (e.g., hostile takeover ramifications, disagreements with management). The intent of this structure is to protect the employee's investment while also providing a means for the employee to defer income taxes. ASC 710 discusses how effects of employer shares held by a rabbi trust should be treated for EPS purposes, as follows:

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Relationships*

*General*

*260-10-60-1*

For the effects of employer shares held by a rabbi trust in computing basic and diluted EPS, see Section 710-10-45.

Compensation — General — Overall

*Other Presentation Matters*

*Deferred Compensation — Rabbi Trusts*

*710-10-45-3*

For all of these types of plans, employer shares held by the rabbi trust shall be treated as treasury stock for earnings per share (EPS) purposes and excluded from the denominator in the basic and diluted EPS calculations. However, the obligation under the deferred compensation arrangement shall be reflected in the denominator of the EPS computation in accordance with the provisions of Section 260-10-45.

*710-10-45-4*

In accordance with paragraph 260-10-45-13, if an obligation is required to be settled by delivery of shares of employer stock (Plan A), those shares shall be included in the calculation of basic and diluted EPS. If the obligation may be settled by delivery of cash, shares of employer stock, or diversified assets (other than Plan A), those shares shall not be reflected in basic EPS but shall be included in the calculation of diluted EPS in accordance with paragraph 260-10-45-30 and paragraphs 260-10-45-45 through 45-46.

Under ASC 710-10-45-3, employer shares held by a rabbi trust should be treated as treasury stock for EPS purposes and excluded from the denominator in the basic and diluted EPS calculations. However, the obligation under the deferred compensation arrangement should be reflected in the denominator of the EPS computation.

If the obligation of the deferred compensation arrangement is required to be settled by delivery of shares of employer stock, those shares should be included in the calculation of basic and diluted EPS in accordance with ASC 260-10-45-13. If the obligation may be settled by delivery of cash, shares of employer stock or diversified assets, the shares should not be reflected in basic EPS but should be included in the calculation of diluted EPS in accordance with ASC 260-10-45-30 and ASC 260-10-45-45 through 45-46.

For additional guidance on ASC 260-10-45-13, see section 3.3.2 on contingently issuable shares. For additional guidance on ASC 260-10-45-30 and ASC 260-10-45-45 through 45-46, see section 4.9 (before the adoption of ASU 2020-06) or section 4.9A (after the adoption of ASU 2020-06) on contracts that may be settled in stock or cash.

For further discussion on the accounting for rabbi trusts, see section 2.7.1 of our FRD, ***Share-based payment***.

## 6.5 Unit structures

Historically, unit structures were a combination of (1) a nonconvertible debt instrument and (2) a variable-share forward contract (or, in some cases, a warrant) that requires the investor to purchase the issuer's common stock at a specified price and time before the maturity of the debt instrument. When viewed on a combined basis, the instruments provide the holder with the economics of a convertible instrument. More recently, we have seen unit structures comprising a convertible preferred stock instrument (rather than nonconvertible debt) and a variable-share forward contract. We discuss these two most common unit structures separately below.

An entity will need to carefully evaluate the components of a unit structure to determine the effect on the diluted EPS calculation. In addition, an entity should evaluate each component to determine whether the two-class method is required (see section 5).

*Unit structure with nonconvertible debt component*

The following illustration summarizes the more significant terms of a typical unit structure with a nonconvertible debt component:

**Illustration 6-3: Typical terms of a unit structure with a nonconvertible debt component**

Company A (the issuer) issues 1 million units to investors in a public offering at $100 per unit. Each unit comprises (1) a three-year variable-share forward purchase contract (the forward contract) and (2) a five-year senior unsecured note with a principal amount of $100.

Key terms of the securities are as follows:

- The note will pay interest at a fixed rate of 1% and mature in five years. At the end of three years, the note will be remarketed. Company A has the option to remarket the note beginning after two years and nine months. Upon the remarketing, the interest rate of the note will be reset such that the proceeds from the remarketing are equal to or greater than the $100 principal amount.
- The forward contract provides that, at the end of three years (the stock purchase date), investors will purchase and the issuer will sell for $100 a number of shares of the issuer's common stock as follows:

| Common stock price* | Number of common shares delivered at settlement |
|---|---|
| Greater than or equal to $120 | 0.83 shares |
| Greater than $100 and less than $120 | Variable number of shares equal to $100 in value |
| Equal to or less than $100 | 1 share |

* Generally based on the weighted average common share price for a period immediately preceding the stock purchase date.

- The forward contract requires the issuer to make quarterly payments to the investors at an annual rate of 6% during the term of the forward contract (the contract adjustment payments). The issuer has the right to defer all or part of these payments until the stock purchase date. Any deferred contract adjustment payments would accrue additional amounts at the rate of 7% (i.e., that rate of total distributions on the units includes the interest on the note of 1% plus the contract adjustment payment of 6%) until paid, compounded quarterly to, but excluding, the stock purchase date. The issuer can elect to settle such payments in cash, shares or a combination of both.
- The interest rate of 1% is the market rate for the issuer based on its credit rating and the terms of the notes at issuance. Therefore, the fair value and par value of each note equals $100 (i.e., there is no premium or discount). The forward contract has an assumed fair value of $16 per unit, which equals the present value of the contract adjustment payments.
- Holders of the units will initially pledge their ownership interests in the notes to secure their obligations to purchase common shares under the forward contracts. If holders want to participate in the remarketing of the notes, they must substitute their ownership interests in the notes with US Treasury securities.

As further discussed in section 5.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, the debt and the equity-linked instrument (e.g., warrant or variable-share forward contract) in a typical unit structure (such as that described in Illustration 6-3) generally are deemed to be freestanding financial instruments because the holder can transfer and settle the equity-linked instrument separately from the debt.

As a result, the instruments within the unit structure are generally accounted for separately, with the proceeds received from issuing the securities allocated to the debt component and the variable-share forward component normally based on their relative fair values. However, these conclusions will vary based on the facts and circumstances of each individual arrangement.

Assuming the variable-share forward contract is not considered a participating security (as discussed in section 5.2.4), ASC 260 provides that all outstanding convertible securities, options, warrants and similar stock rights (including forward contracts) must be considered in the computation of diluted EPS, utilizing either the "if-converted method" or the "treasury stock method" as appropriate, to the extent that they are dilutive (as discussed in section 4).

Further, ASC 260-10-55-9 (excerpted below) specifies that where options or warrants (as well as forward contracts) permit or require the tendering of debt or other securities of the issuer (or its parent or subsidiary), it should be assumed that the if-converted method applies, unless tendering cash would be more advantageous to the option holder and the contract so permits. In this latter case, the treasury stock method would apply.

### Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Options and Warrants and Their Equivalents*

*260-10-55-9*

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.

The issue of whether to apply the treasury stock method or if-converted method frequently arises in connection with unit structures that involve a debt instrument and either a variable-share forward contract or a warrant. As noted in Illustration 6-3 above, a typical unit structure includes a note with a term of five years and a forward contract (i.e., the investor must purchase the issuer's shares in the future) that is settled at the end of three years. At least three months before the settlement of the forward, the debt instrument is remarketed, and a new interest rate is established on the debt to yield net sale proceeds at least equal to the par amount of the debt.

If the remarketing is successful, the investor can elect to either participate in the remarketing and retain the debt (with a remaining term of two years and three months) or sell the debt in the remarketing and receive the cash proceeds (the debt or the cash proceeds are held by the collateral agent to secure performance under the forward contract). If the remarketing is unsuccessful, the investor may put the debt back to the issuer in satisfaction of the forward purchase price.

We believe that to use the treasury stock method to calculate the dilutive effect of the forward contract, an entity would need to conclude that it is probable that the remarketing of the debt instrument will be successful, and therefore, the debt cannot be put to the issuer in satisfaction of the forward purchase price. Accordingly, as long as it is probable that the remarketing will occur, the calculation of the dilutive effect of the forward or warrant using the treasury stock method is appropriate.

If and when it is no longer probable that a remarketing will be successful, the issuer should assume that the investor will tender the debt to satisfy the forward or warrant exercise price, and, therefore, the if-converted method is applied. Previously reported EPS amounts should not be adjusted upon a change in the probability of a successful remarketing. The individual facts and circumstances, and specific contractual terms, of any financing transaction should be considered carefully in evaluating the appropriate accounting and related EPS treatment.

## How we see it

We believe an entity should consider how much discretion it has to change the terms of the debt instrument upon its remarketing in a typical unit structure. An entity's ability to modify the terms, in addition to the interest rate (e.g., dividend rate, maturity), to increase the likelihood of a successful remarketing may suggest that the investor is, in substance, tendering the debt with the original terms to the entity in payment of some or all of the exercise price of the forward, with the entity effectively issuing a new debt instrument to new investors in the remarketing. If this is the case, the use of the treasury stock method for computing diluted EPS may not be appropriate.

An entity should also consider the EPS effect of any contract adjustment payments. As further discussed in section 5.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, the present value of the contract adjustment payments is generally accounted for as a liability and subsequently accretes and settles periodically over the term of the forward contract, with the resulting expense recognized as interest.

If an entity can elect to settle such payment in cash, shares or a combination of both, the entity should consider the ASC 260 guidance in section 4.9 (before the adoption of ASU 2020-06) or section 4.9A (after the adoption of ASU 2020-06) on contracts that can be settled in stock or cash to determine how the contract adjustment payments should be considered in the diluted EPS calculation.

*Unit structure with convertible preferred stock component*

The following illustration summarizes the more significant terms of a unit structure with a convertible preferred stock component:

**Illustration 6-4: Typical terms of a unit structure with a convertible preferred stock component**

Company A (the issuer) issues $100 million of units to investors in a public offering at $100 per unit. Each unit consists of (1) a three-year variable-share forward purchase contract (the forward contract) and (2) one share of 0% Series A Convertible Preferred Stock (the convertible preferred stock) of Company A, with no par value and a liquidation preference of $100 per share.

Key terms of the securities are as follows:

*Convertible preferred stock*

- The convertible preferred stock has an initial dividend rate of 0%. At the end of three years, the convertible preferred shares will be remarketed. Company A has the option to remarket the shares beginning after two years and nine months. Upon the remarketing, key terms of the convertible preferred stock, including the dividend rate, the conversion rate and the optional redemption date, may be modified to realize proceeds from the remarketing equal to or greater than the $100-per-share liquidation preference. Dividends may be paid in cash, common stock or a combination of both at Company A's option.
- On or after three years, holders can convert the convertible preferred shares at any time. The conversion rate is initially 0.83 common shares per preferred share, which equates to an initial conversion price of $120 per share. The conversion rate is subject to adjustment in certain circumstances (e.g., when dividends are paid to common shareholders above a stated per-share amount equal to the issuer's normal dividend). Upon conversion, the settlement amount can be settled in cash, shares or a combination of both at Company A's option.
- Company A can redeem the shares on or after three years at the liquidation price of $100 per share, plus any accumulated but unpaid dividends.
- Holders of the units will initially pledge their ownership interests in the convertible preferred stock to secure their obligations to purchase common shares under the forward contracts. If holders want to participate in the remarketing of the convertible preferred stock, they must substitute their ownership interests in the convertible preferred stock with US Treasury securities.

*Forward contract*

- The forward contract provides that, at the end of three years (the stock purchase date), investors will purchase and the issuer will sell for $100 a number of shares of the issuer's common stock as illustrated in the following table. The number of shares to be delivered at settlement is subject to adjustment in certain circumstances (e.g., when dividends are paid to common shareholders above a stated per-share amount equal to the issuer's normal dividend):

| Common stock price* | Number of common shares delivered at settlement |
|---|---|
| Greater than $100 | Variable number of shares equal to $100 in value |
| Less than or equal to $100 | 1 share |

* Generally based on the weighted average common share price for a period immediately preceding the stock purchase date.

- The forward contract requires the issuer to make quarterly payments to the investors at an annual rate of 7% during the term of the forward contract (the contract adjustment payments). The issuer has the right to defer all or part of these payments until the stock purchase date. Any deferred contract adjustment payments would accrue additional amounts at the rate of 7% until paid, compounded quarterly to, but excluding, the stock purchase date. The issuer may elect to settle such payment in cash, shares or a combination of both.
- The forward contract has an assumed fair value of $16 per unit, which equals the present value of the contract adjustment payments.

As noted in the illustration above, this type of unit structure includes convertible preferred stock and a forward contract (i.e., the investor must purchase the issuer's shares in the future) that is settled at the end of three years. At least three months before the settlement of the forward, the convertible preferred stock is remarketed where several terms can be modified. If the remarketing is successful, the investor can elect to either participate in the remarketing and retain the convertible preferred stock or sell the instrument in the remarketing and receive the cash proceeds (the convertible preferred stock or the cash proceeds are held by the collateral agent to secure performance under the forward contract). If the remarketing is unsuccessful, the investor may put the convertible preferred stock back to the issuer in satisfaction of the forward purchase price.

As further discussed in section 5.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, the convertible preferred stock and the forward contract depicted in the illustration above are evaluated to determine whether each is a separate instrument to be accounted for separately or the instruments should be combined and accounted for as one unit of account.

In the fact pattern above, the convertible preferred stock and the forward contract are combined and accounted for as one unit based on an analysis of the relevant facts (e.g., they share the same risk). In other words, the forward contract is considered an embedded feature within the convertible preferred stock and the combined instrument represents mandatorily convertible preferred stock with embedded equity-linked features (the forward contract, conversion option and redemption option). However, this evaluation will require significant judgment based on the facts and circumstances of the arrangement.

The dilutive effect of a unit structure that is accounted for as a single unit of account (i.e., a mandatorily convertible preferred stock instrument) should be included in diluted EPS through the application of the if-converted method (i.e., ASC 260-10-45-40 through 45-42 discussed in section 4.6).

Even if the convertible preferred stock and forward contract are each accounted for separately, the use of the if-converted method is likely required under ASC 260-10-55-9 (excerpted above) because, in substance, the tendering of the convertible preferred stock is required to exercise the variable-share forward contract. The terms of the convertible preferred stock provide the entity with discretion to change multiple features of the instrument upon remarketing (i.e., the conversion and dividend rates and the redemption date). This discretion indicates that the holders of the convertible preferred stock are tendering the original instrument back to the entity, resulting in the entity's reacquisition of the original instrument and issuance of a new instrument with different terms.

With the application of the if-converted method (as discussed in section 4.6) to the unit structure, the incremental shares added to the denominator of the diluted EPS calculation would include the shares of common stock necessary to settle the forward. Because the number of shares is variable (i.e., due to changes in the settlement rate resulting from changes in the underlying common stock price), entities should consider the ASC 260 guidance in section 4.6.1 (before the adoption of ASU 2020-06) or section 4.6.1A (after the adoption of ASU 2020-06).

To calculate the dilutive effect of the convertible preferred stock component of the unit structure, an entity should consider the ASC 260 guidance in section 4.9.1 (before the adoption of ASU 2020-06) or section 4.9.1A (after the adoption of ASU 2020-06), because it typically can settle these instruments in cash, shares or a combination of both. While the guidance in those sections discusses convertible debt that can be settled in stock or cash, we believe entities typically apply it to convertible preferred stock instruments where the issuer is required or has the option to satisfy all or part of the obligation in cash.

Entities would also need to evaluate each component of the unit structure to determine whether the component participates in undistributed earnings with common stock, and therefore, the two-class method (see section 5) would be required for computing EPS. For example, as discussed in the illustrations above, the settlement rate of the forward contract and the conversion rate of the convertible preferred stock will be adjusted if dividends are paid to common shareholders in excess of a certain per share amount. Such a price adjustment feature will need to be evaluated to determine whether it constitutes a participation right.

Finally, an entity should also consider the EPS effect of any contract adjustment payments. As discussed above and in section 5.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06)*** or ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06)***, the present value of the contract adjustment payments is generally accounted for as a liability and subsequently accretes and settles periodically over the term of the forward contract, with the resulting expense recognized as interest.

If an entity can elect to settle such payment in cash, shares or a combination of both, it should consider the ASC 260 guidance in section 4.9 (before the adoption of ASU 2020-06) or section 4.9A (after the adoption of ASU 2020-06) for contracts that can be settled in stock or cash to determine how the contract adjustment payments should be considered in the diluted EPS calculation.

## 6.6 EPS computations of nominal issuances in an IPO (updated August 2023)

SAB Topic 4.D (codified in ASC 260-10-S99-1 excerpted below) applies to pre-IPO issuances of common stock and potential common stock that are considered to be "nominal issuances," defined as securities issued for "nominal consideration." The model in SAB Topic 4.D is based upon comparing the consideration paid (including the value of any goods and services provided) to the fair value of the equity security at the time of issuance.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*SEC Materials*

*SAB Topic 4.D, Earnings Per Share Computations in an Initial Public Offering*

*260-10-S99-1*

The following is the text of 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.

In computing basic EPS, nominal issuances of common stock must be reflected in basic EPS for all periods in a manner similar to a stock split, even if antidilutive. In computing diluted EPS, nominal issuances of both common stock and potential common stock (e.g., options, warrants, other convertible securities) should be reflected in a manner similar to a stock split, even if antidilutive. All nominal issuances that occur during any of the periods covered by statements of operations that are included in an IPO are subject to the requirements of SAB Topic 4.D. Refer to section 7.3.1 for further EPS guidance on stock splits.

Based on our discussions with the SEC staff, we have learned the following:

- The SEC staff expects "nominal issuances" rarely will occur. In the staff's view, issuances of equity securities that are accounted for under ASC 718 generally will not be considered "nominal issuances" because any goods or services received represent consideration paid for the securities issued.[21]
- The SEC staff will scrutinize any transaction treated as a nominal issuance to determine whether compensation or another type of expense should have been recognized.
- The SEC staff cited several examples of the types of transactions the staff envisioned would be covered by SAB Topic 4.D. The examples involve issuances to nonemployee owners or others (e.g., promoters)[22] that did not involve goods or services, such as shares or options issued for little or no consideration in lieu of dividends or issuances that are part of a broader recapitalization or restructuring of equity.
- Use of the treasury stock method to measure the dilutive effect of "nominal issuances" of stock options and warrants is not permitted when computing diluted EPS for pre-IPO periods. The SEC staff believes that, if the exercise price is nominal, the proceeds from exercise would be immaterial and should be disregarded. Thus, a registrant must treat all the shares under option as outstanding with no effect given to the exercise price.

SAB Topic 4.D only addresses nominal issuances that occur during any of the periods covered by statements of operations that are included in an IPO. However, the SEC staff has stated[23] that this guidance should be applied in an IPO and subsequent filings.

The following example illustrates ASC 260's guidance on computing EPS for nominal issuances in an IPO:

**Illustration 6-5: Calculation of EPS for nominal issuances in an IPO**

Company A, a calendar year-end company, completes an IPO on 1 July 20X6. On 1 January 20X4, Company A issued to nonemployee shareholders 10,000 shares for $0.01 per share. On 1 January 20X5, Company A issued options to a promoter of the Company for 5,000 shares with an exercise price of $1. The options were issued to the promoter as part of a recapitalization of the Company and not as consideration for the promoter's services. The fair value of the Company's common stock prior to the IPO was estimated at $20, $25 and $30 per share in 20X3, 20X4 and 20X5, respectively. Company A includes audited financial statements for the years ended 31 December 20X3, 20X4 and 20X5 and unaudited financial statements for the quarter ended 31 March 20X6 as part of the registration statement. For its first 10-K filed for 20X6, it files audited financial statements for the years ended 31 December 20X4, 20X5 and 20X6.

For the audited financial statements for annual periods prior to the IPO (i.e., 20X3 — 20X5) and the unaudited financial statements for the quarter ended 31 March 20X6, Company A must include the 10,000 shares issued to nonemployees in the denominator for basic EPS and 15,000 shares in the denominator for diluted EPS for the shares and options issued even if the effect is antidilutive. The 5,000 shares relating to the options issued to the promoter are not included in basic EPS because they represent "potential common stock," which is excluded from basic EPS. This treatment is applied to 20X3 even though the shares and options were not issued until 20X4 and 20X5, respectively. Further, no effect is given to the exercise price of the options. The Company also would treat the shares and options in this manner for the quarter ended 30 June 20X6 prior to the effective date of the IPO, as well as in subsequent filings.

[21] SEC staff's Division of Corporation Finance Financial Reporting Manual Section 7520.2(a).
[22] SEC staff's Division of Corporation Finance Financial Reporting Manual Section 7520.2(c).
[23] SEC staff's Division of Corporation Finance Financial Reporting Manual Section 7520.2(b).

## 6.6.1 Nominal consideration

### 6.6.1.1 Definition of nominal

A challenging aspect of SAB Topic 4.D is determining what constitutes nominal consideration. The only guidance provided in SAB Topic 4.D is a footnote that states nominal consideration is determined based on facts and circumstances particular to the registrant, and that the SEC staff will look to the fair value of the consideration received and compare it to the fair value of the equity instrument issued. The SEC staff did not establish any bright line percentages of fair value that would or would not be considered "nominal."

Our discussions with the SEC staff indicate that the consideration received must be immaterial for an issuance to be considered nominal, and the staff expects nominal issuances to be rare. Most would agree that if the consideration received for the equity security is less than 10% of its value at the date of issuance, the consideration would be considered "nominal." In determining whether an issuance is nominal in the absence of more definitive guidance from the SEC staff, the determination should focus on the nature of the transaction. The more closely the transaction resembles a recapitalization, the more likely it would be considered a nominal issuance.

### 6.6.1.2 Definition of consideration

SAB Topic 4.D does not define "consideration." However, as discussed previously, it is not intended to be limited to cash proceeds. Consideration also includes the value of goods and services received. As mentioned above, issuances of equity securities in consideration for goods or services that are accounted for under ASC 718 generally would not be considered nominal issuances. The following examples illustrate these concepts:

**Illustration 6-6: Stock options issued in exchange for goods or services**

If employees were granted options to acquire shares that vest over five years and the fair value of the options is $10, the entity would recognize $10 in compensation cost over the five-year vesting period under ASC 718. Thus, SAB Topic 4.D would view the consideration as the $10 in compensation cost related to the services to be received over the five-year period. (If the IPO price is significantly above the fair value of the stock used to value the option on the grant date, the SEC staff could challenge the determination of the fair value of the option and the resulting amount of compensation cost recognized). This transaction would not be a "nominal issuance" under SAB Topic 4.D because the consideration for the option would include the value of the services received (i.e., the compensation cost), which is equal to the fair value (or fair value-based measure) of the option. Since the consideration is equal to the security's fair value, it is not nominal.

**Illustration 6-7: Stock options issued that are not in exchange for goods or services**

Nominal issuances may include transactions with owners and promoters in which no goods and services are received by the issuer (as a result, no compensation cost is recognized), and the consideration paid for the issuance is insignificant when compared to the fair value of the instruments issued. For example, if an entity issues options to owners with a strike price of $1, 18 months prior to an IPO, when the fair value of the stock was $10, and no goods or services are provided, SAB Topic 4.D requires those shares under option be reflected as outstanding for diluted EPS for all periods presented similar to a stock split (see section 7.3.1), even if antidilutive.

## 6.7 EPS for carve-out of existing business or spin-off of previously existing subsidiary

When calculating basic EPS for a carve-out of an existing business (e.g., a discrete business that represents a portion of a legal entity or a group of businesses held by multiple legal entities controlled by the same parent) that has been spun off or taken public through an IPO, entities typically use the number of shares distributed in the spin-off or held by the parent immediately prior to the IPO as the denominator for historical EPS for each period presented.

Companies may use a similar approach when a previously existing wholly or partially owned subsidiary (i.e., a separate legal entity prior to the offering) has been spun off or taken public through an IPO; however, the weighted average number of shares historically outstanding may also be acceptable based on the facts and circumstances.

In a spin-off or IPO of an existing subsidiary, the number of common shares may be increased through a stock split. If the number of common shares increases as a result of a stock split, the number of shares used to calculate basic EPS should be adjusted retroactively for all periods presented to reflect the change in capital structure (see section 7.3.1). When an entity issues shares to new investors in an IPO, we believe that the newly issued shares should be included in basic EPS prospectively from the date of issuance.

If a carve-out transaction results in the formation of a new public entity (e.g., a division of an entity is reorganized into a newly formed public entity), then any financial statements issued subsequent to the transaction must include EPS information in the comparative historical periods previously covered by the carve-out financial statements.

When calculating basic EPS for a carve-out of a newly formed entity, the denominator for the periods prior to formation could be the number of shares at formation or the number of shares held by the parent immediately prior to the carve-out transaction. When calculating diluted EPS, the dilutive effects of the carve-out entity's stock options should be considered.

## 6.8 Pro forma EPS

Numerous circumstances may arise primarily in connection with an IPO that warrant the presentation of pro forma EPS. In addition, full pro forma financial information pursuant to Article 11 of Regulation S-X may be required in certain filings with the SEC (e.g., Form 8-K reporting the acquisition or disposition of a significant business, registration statements, certain proxy statements) to reflect certain transactions or events that have occurred or are probable of occurring. In such circumstances, the pro forma statement of operations should include historical and pro forma basic and diluted EPS based on continuing operations attributable to the registrant and the number of shares used in the computation, on both a historical and pro forma basis. In addition, disclosure of pro forma EPS may be necessary in some circumstances when full Article 11 pro forma financial information is not required.

It should be noted that the presentation of pro forma EPS data does not change the calculation or presentation of historical EPS under ASC 260. Specifically, transactions that have not yet occurred (e.g., conversions, distributions), but will occur in connection with the IPO, do not affect historical EPS prior to their occurrence unless specific provisions within ASC 260 provide otherwise (e.g., stock splits (see section 7.3.1), rights issues (see section 7.3.2)). This section includes SEC staff guidance and provides examples regarding certain circumstances that require presentation of pro forma EPS in registration statements. Also see our SEC Financial Reporting Series publication, *Pro forma financial information*.

## 6.8.1 Pro forma EPS reflecting the use of offering proceeds

Pro forma EPS measures are often required to reflect a company's use of proceeds to make various payments that are associated with an offering. Generally, the pro forma EPS denominator should include only common shares whose proceeds are reflected in pro forma adjustments in the pro forma statement of operations (e.g., adjustments associated with proceeds used to repay outstanding debt or for a business acquisition). Common shares whose proceeds will be used for general corporate purposes should not be included in the denominator for pro forma EPS.

In addition, as discussed further in section 6.8.1.1 below and in section 6.1.2 of our SEC Financial Reporting Series publication, *Pro forma financial information*, SAB Topic 1.B.3 (codified in ASC 855-10-S99-1) requires that shares, for which the offering proceeds are assumed to be used to pay dividends, be included in the pro forma EPS denominator. This is required even though the pro forma transaction (e.g., payment of dividend in connection with an IPO) does not result in an adjustment to the pro forma statement of operations.

Historically, the SEC staff has required companies to present the additional pro forma disclosures required in SAB Topic 1.B.3 in or alongside the historical financial statements in their IPO registration statements. However, amended Rule 11-02(a)(12) states that registrants cannot present pro forma financial information on the face of their historical financial statements or in the accompanying notes, except when such presentation is required by other GAAP, as applicable. As a result, we believe registrants should determine whether additional pro forma information is material and evaluate the appropriate location for such disclosures. In all cases, registrants should include transparent disclosure about how pro forma EPS measures are calculated.

### 6.8.1.1 Offering proceeds used to pay dividends in excess of current year earnings or total offering proceeds at or prior to closing of an IPO

The SEC staff has provided its views in SAB Topic 1.B.3 about the presentation of pro forma EPS when proceeds from an IPO of a subsidiary's equity are used to pay dividends to its prior owners, promoters and/or parents. It is important for registrants to consider the applicability of this guidance when calculating pro forma EPS even when the stated use of proceeds in the capitalization table of a registration statement does not include payment of such dividends. The pro forma presentation requirements of this SAB Topic are applicable to dividends paid at or prior to closing of an IPO that are greater than the current year's earnings. The SEC staff assumes that offering proceeds will be used to replenish capital used to pay dividends within 12 months of the offering if those dividends exceed earnings during the prior 12 months.[24]

The purpose of considering these dividends in pro forma EPS is to include the effect of common shares for which a registrant would have to raise proceeds to pay the portion of dividends exceeding current year's net income, which has been interpreted to mean the most recent 12 months. The shares that are assumed issued are added to historical shares outstanding in the denominator of the pro forma EPS calculation. The number of shares added to historical shares outstanding in the denominator should not exceed the total number of shares issued in the offering.

In these circumstances, pro forma EPS should be presented only for the most recent annual and interim periods.

[24] SEC staff's Division of Corporation Finance Financial Reporting Manual Section 3420.

The following illustration is an example pro forma EPS calculation that includes the effect of these additional shares whose proceeds were assumed to be used to fund dividends:

**Illustration 6-8: Pro forma EPS — dividends in excess of current year earnings**

Company A has decided to undertake an IPO of its common stock. Prior to its IPO, Company A had 100,000 shares of issued and outstanding common stock. Company A will sell 800,000 shares in the IPO for $6.25 per share. The offering will yield total gross proceeds (i.e., before underwriting discounts and other expenses) of $5 million. Company A's net income for the previous 12 months was $1 million.

**Scenario 1:**

Company A will use the proceeds from its IPO together with the funds provided by a bank line of credit to pay a $3.5 million dividend to its shareholders at the time of closing.

In this scenario, the dividend of $3.5 million exceeds the most recent year's net income of $1 million but is not greater than total offering proceeds of $5 million. The $2.5 million ($3.5 million dividend less $1 million net income) represents the amount of the dividend in excess of current year earnings which is deemed to be paid from the offering proceeds. Because this excess does not exceed total offering proceeds, only a portion of the total 800,000 shares issued would be added to the historical 100,000 shares in the pro forma EPS denominator. To pay the excess $2.5 million dividend, Company A would have to issue 400,000 shares ($2.5 million excess dividend divided by the offering price per share of $6.25). Therefore, the pro forma EPS denominator would be calculated as follows:

| | |
|---|---|
| Pre-existing (historical) shares | 100,000 |
| IPO shares required to fund divided in excess of earnings | 400,000 |
| Pro forma shares | 500,000 |

**Scenario 2:**

Company A will use the proceeds from its IPO together with the funds provided by a bank line of credit to pay a $15 million dividend to existing shareholders at the time of closing.

In this scenario, the amount of the dividend that Company A will pay shareholders at the closing date of the IPO ($15 million) exceeds Company A's net income for the previous 12 months ($1 million). Therefore, a portion of the dividend is deemed paid from the proceeds of the IPO. Since the amount of the dividend in excess of Company A's net income for the previous 12 months ($14 million) exceeds the gross proceeds of the IPO ($5 million), Company A should include all 800,000 of the shares offered in the IPO in the denominator of the pro forma EPS calculation. Therefore, the pro forma EPS denominator would be calculated as follows:

| | |
|---|---|
| Pre-existing (historical) shares | 100,000 |
| Total IPO shares | 800,000 |
| Pro forma shares | 900,000 |

To present a transparent picture for the investor, the numerator of the pro forma EPS computation in Scenario 2 also should be adjusted to reflect the incremental interest expense (net of tax) assumed incurred to finance the portion of the dividend that exceeds both the gross proceeds from the equity offering and the previous 12 months' earnings ($9 million in this example, or the $15 million dividend less $1 million in earnings and $5 million in IPO proceeds).

### 6.8.1.2 Offering proceeds used to extinguish debt

A registrant may indicate in its registration statement (in its *Use of Proceeds* disclosure) that proceeds from a securities offering will be used to extinguish existing debt. SAB Topic 3.A states that registrants must consider material effects on pro forma EPS when registering convertible preferred stock or debentures whose proceeds will be used to extinguish existing preferred stock or debt. In addition, the SEC staff has commented that registrants also should apply this concept when proceeds from a common stock offering will be used to extinguish debt.

When proceeds from the sale of common stock will be used to extinguish debt, a registrant must include, in its pro forma EPS denominator, the number of common shares that would be required to be sold in the offering to retire the existing debt. The assumed number of common shares issued may be less than the total number of shares offered. Registrants would use the offering price per common share to calculate the number of assumed common shares issued, and the assumed common shares are only calculated for the period that the debt was issued or for the entire pro forma income statement period if the debt was issued prior to the beginning of the period.

In addition to adjusting the denominator, pro forma net income also would be adjusted to eliminate interest expense, net of the related tax effect. This interest expense must be directly attributable to the debt retired.

The following example illustrates how the pro forma EPS calculation would give effect to the additional common shares assumed issued to extinguish debt:

**Illustration 6-9: Pro forma EPS when proceeds of common shares used to extinguish debt**

Company A is a calendar year company that is planning to file its initial registration statement on Form S-1 in May 20X3 to offer 100,000 common shares at $10 per share to raise gross proceeds of $1 million.

Company A reported the following for the fiscal year ended 31 December 20X2:

| | |
|---|---|
| Net income | $ 1,500,000 |
| Weighted average shares outstanding | 250,000 |
| Basic EPS | $6.00 |
| Effective tax rate | 40% |

Company A intends to retire $700,000 of term debt with proceeds from the offering. In fiscal year 20X2, interest expense on the debt was $52,500. The total principal amount of $700,000 has an annual interest rate of 10%, with the following issue dates:

$350,000 — issued on 1 January 20X1

$350,000 — issued on 1 July 20X2

Pro forma EPS — Basic calculation (for fiscal 20X2):

Adjustments to net income (a)

| | | |
|---|---|---|
| As reported | | $1,500,000 |
| Add: interest expense | | 52,500 |
| Less: tax effect | | (21,000) |
| As adjusted | | $1,531,500 |
| Calculation of additional shares | Total | Average |
| Shares, as reported | | 250,000 |
| Additional shares — | | |
| 1 January 20X1 issuance | 35,000 | 35,000 (b) |
| 1 July 20X2 issuance | 35,000 | 17,500 (c) |
| Shares, as adjusted | | 302,500 |
| Pro forma EPS — basic | | $5.06 |

(a) The pro forma adjustments to net income in this illustration are only those that pertain to this topic. Other adjustments to net income per Article 11 of Regulation S-X also may be included in the pro forma statement of operations.

(b) Because this principal amount of debt was issued on 1 January 20X1, it has been outstanding for the entire 12-month period ended 31 December 20X2. Therefore, the number of common shares issued is calculated as 35,000 ($350,000 principal / $10 per common share offered).

(c) Because this principal amount of debt was issued on 1 July 20X2, it has been outstanding for half the 12-month period ended 31 December 20X2. Therefore, the number of common shares issued is calculated as 17,500 (($350,000 principal / $10 per common share offered) x 0.5 (6 months / 12 months)).

## 6.8.2 Other circumstances resulting in pro forma EPS presentation

### 6.8.2.1 Change in tax status in connection with an IPO

Many private companies are organized as nontaxable entities (e.g., S corporations, limited-liability corporations, partnerships) to minimize the tax burden on the equity owners. However, prior to consummation of an IPO, these companies often convert to C corporations, which are taxable entities. In such circumstances, the SEC staff expects IPO registrants to present pro forma income tax and pro forma EPS.[25] Presentation is generally limited to the most recent annual and interim periods included in the registration statement. However, if the pro forma adjustments relate to only income taxes (i.e., the IPO registration statement does not include any other pro forma information for other events or transactions), the SEC staff encourages registrants to present pro forma income tax and pro forma EPS for all periods included in the historical financial statements.

If a registrant elects to present pro forma information for all periods, as noted above, pro forma income tax and EPS measures for earlier comparable periods should continue to be presented in SEC filings made after the IPO. Pro forma income tax in comparable periods should continue to be calculated using the statutory tax rates that were effective in prior periods.

Subchapter S corporations or partnerships that pay distributions to promoters/owners at the closing or effective date with proceeds of the offering (rather than out of current earnings) should consider the pro forma EPS presentation described in section 6.8.1.1.

[25] SEC staff's Division of Corporation Finance Financial Reporting Manual Section 3410.

#### 6.8.2.2 Changes in capital structure in connection with an IPO

In connection with an IPO, certain outstanding securities (e.g., convertible debt, convertible preferred stock, restricted stock units) may be converted into common equity of the registrant. If such conversion will occur after the latest balance sheet date presented in the IPO registration statement and will materially affect EPS (excluding the effects of the offering), pro forma EPS for the latest annual and interim periods should be presented. This pro forma EPS calculation should give effect only to the assumed conversion of outstanding securities and not the offering.[26] Pro forma EPS reflecting the assumed conversions should be included in the registration statement in addition to historical EPS.

### 6.8.3 Pro forma EPS presentation in SEC filings after IPO

Other than the limited circumstance discussed in section 6.8.2.1, pro forma EPS generally should not be presented in financial statements issued after the IPO.

**Illustration 6-10: Subsequent filing example**

A calendar year registrant's IPO registration statement on Form S-1 included pro forma EPS information to reflect the conversion of preferred stock to common shares for the most recent interim and annual periods included in the registration statement (the six months ended 30 June 20X2 and the fiscal year ended 31 December 20X1, respectively).

If the registration statement has an effective date of 2 October 20X2, the registrant would not present the pro forma EPS information in its third quarter 20X2 financial statements filed on Form 10-Q even though the pre-IPO capital structure was still in place as of 30 September 20X2.

[26] SEC staff's Division of Corporation Finance Financial Reporting Manual Section 3430.3.

# 7 Presentation and disclosure

## 7.1 Presentation (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Other Presentation Matters*

*General*

*260-10-45-1*

This Section provides guidance pertaining to presentation of **basic** and **diluted earnings per share** (EPS).

*Required EPS Presentation on the Face of the Income Statement*

*260-10-45-2*

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.

*260-10-45-3*

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.

*260-10-45-4*

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.

*260-10-45-5*

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. (See paragraph 260-10-50-1A.)

*260-10-45-6*

Paragraph 230-10-45-3 prohibits reporting an amount of cash flow per share.

*260-10-45-7*

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.

*260-10-45-8*

See Example 1 (paragraph 260-10-55-38) for an illustration of this guidance.

Under ASC 260, EPS must be presented for each period a statement of operations is presented. Entities with simple capital structures (i.e., no potentially dilutive securities) are required to present basic per-share amounts for both income from continuing operations and net income on the face of the statement of operations. All other entities are required to present both basic and diluted per-share amounts for income from continuing operations and net income on the face of the statement of operations with equal prominence. If diluted EPS is presented for any period, it must be presented for all periods even if it is the same amount as basic EPS. The terms "basic" and "diluted" are not required to be used. Other terms, such as "earnings per common share" and "earnings per share — assuming dilution," may be used.

In addition, the US GAAP interim guidance in ASC 270-10-50-1(b) requires entities to report "basic and diluted earnings per share data for each period presented, determined in accordance with the provisions of Topic 260." SEC Regulation S-X also requires SEC registrants to present EPS in their quarterly reports on Form 10-Q and annual reports on Form 10-K.

As discussed in section 5.3, ASC 260-10-45-60B only requires presentation in the financial statements of basic and diluted EPS under the two-class method for each class of common stock. That is, although basic and diluted EPS would be calculated for multiple classes of common stock and each participating security, presentation in the financial statements is only required for classes of common stock. Disclosure of the basic and diluted EPS amounts for a participating security is permitted but not required.

Entities that report discontinued operations must present basic and diluted per-share amounts for that line item either on the face of the statement of operations or in the notes to the financial statements in accordance with ASC 260-10-45-3. Given the emphasis placed on EPS information by financial statement users, we recommend that such information be presented on the face of the statement of operations.

Income from continuing operations and net income should exclude amounts attributable to noncontrolling interests, if any. In other words, the numerator of the EPS calculation should begin with income from continuing operations attributable to the parent and net income attributable to the parent (see section 3.2).

ASC 260 requires that diluted EPS be presented if it is different from basic EPS without regard to materiality. In the Basis for Conclusions of Statement 128,[27] the FASB noted that the standard materiality clause contained in all FASB Statements (i.e., "The provisions of this Statement need not be applied to immaterial items.") does not apply to the difference between two numbers, and that dual presentation of basic and diluted EPS is required regardless of the difference between the two numbers.

If an entity chooses to present any per-share amounts not required by ASC 260, the per-share amounts should be computed in accordance with ASC 260 and disclosed only in the footnotes to the financial statements (i.e., not presented on the face of the financial statements). The entity should also note whether the per-share amounts are pretax or net of tax.

[27] Paragraphs BC126 through BC132 of Statement 128.

The following example illustrates ASC 260's guidance on presentation of EPS in the statement of operations. Also see Example 1 from ASC 260 in Appendix E.

**Illustration 7-1: Statement of operations presentation**

The following illustrates how an entity might present its EPS data in its statement of operations. Note that the per-share amounts for the discontinued operations are required to be disclosed but are not required to be shown on the face of the statement of operations. Instead, they may be presented in the footnotes.

| | 20X3 | 20X2 | 20X1 |
|---|---|---|---|
| Earnings per common share: | | | |
| Income (loss) from continuing operations | $ 1.87 | $ 1.50 | $ (0.63) |
| Loss on discontinued operations | (0.50) | – | – |
| Net income (loss) per common share | $ 1.37 | $ 1.50 | $ (0.63) |
| Earnings per common share — assuming dilution: | | | |
| Income (loss) from continuing operations | $ 1.73 | $ 1.36 | $ (0.63) |
| Loss on discontinued operations | (0.46) | – | – |
| Net income (loss) per common share — assuming dilution | $ 1.27 | $ 1.36 | $ (0.63) |

Further, ASC 220-20-45-1 requires a material event or transaction that is of an unusual nature, or occurs infrequently (or both), to be presented as a separate component of income from continuing operations. These items should not be presented in the income statement net of tax, and the EPS effect of those items should not be presented on the face of the income statement. However, the net of tax or EPS effects may be presented in the notes.

### 7.1.1 Interaction of discontinued operations and noncontrolling interests

In accordance with ASC 205-20-45-3, income (loss) from discontinued operations is presented on the face of the financial statements. ASC 205-20-50-5B(d) requires disclosure (if not presented on the face of the financial statements as part of discontinued operations) of the pretax profit or loss attributable to the parent if the discontinued operation includes a noncontrolling interest. The portion of income or loss from discontinued operations attributable to the parent also must be disclosed, or included on the face of the financial statements, pursuant to ASC 810-10-50-1A. Entities should then present net income attributable to the noncontrolling interest (including amounts generated from both continuing and discontinued operations) below consolidated net income when determining the net income attributable to the issuer.

The calculation of basic earnings per share starts with income from continuing operations, which excludes both any income (loss) from discontinued operations and any income (loss) attributable to the noncontrolling interest. The example below illustrates this guidance.

**Illustration 7-2: EPS calculation when there is a noncontrolling interest**

Assume the following for an entity:

- Income from discontinued operations of $200, includes $25 of income attributable to noncontrolling interests
- Income attributable to noncontrolling interests of $100, including $75 from continuing operations and $25 from discontinued operations
- No dividends declared during the period
- Common shares outstanding during the period of 1,000

The following is an excerpt of an entity's income statement:

| | 20X9 |
|---|---|
| Income from continuing operations | $ 1,000 |
| Discontinued operations | 200 |
| Consolidated net income | 1,200 |
| Income attributable to noncontrolling interest | (100) |
| Net income attributable to common shareholders of the parent | $ 1,100 |

Basic EPS for common shareholders would be calculated and presented (on the face of the income statement or in the notes to the financial statements) as follows:

| | | | |
|---|---|---|---|
| Income from continuing operations | $ 1,000 | | |
| Net income from continuing operations attributable to noncontrolling interest | (75) | (a) | |
| Income available to common shareholders, before discontinued operations | 925 | | $ 0.93 |
| Discontinued operations | 175 | (b) | $ 0.18 |
| Net income attributable to common shareholders | $ 1,100 | | $ 1.11 |

(a) Comprises $75 income attributable to noncontrolling interests for continuing operations.

(b) Calculated as $200 total discontinued operations net of the $25 income attributable to noncontrolling interests in discontinued operations.

### 7.1.2 Non-GAAP per-share amounts

For SEC registrants, the disclosure in the notes to the financial statements of a per-share amount related to an element within the GAAP statement of operations (e.g., a restructuring charge) would not meet the definition of a non-GAAP financial measure in Item 10(e) of Regulation S-K. However, an SEC registrant's presentation of an earnings per-share amount adjusted to exclude such an element would meet the definition of a non-GAAP financial measure.

Item 10(e) of Regulation S-K specifically prohibits the presentation of a non-GAAP financial measure in the financial statements, including the notes to the financial statements, filed with the SEC unless the measure is required or expressly permitted by the standard setter that is responsible for establishing GAAP used in such financial statements. Item 10(e) also imposes certain requirements and restrictions on any disclosure of a non-GAAP financial measure elsewhere in an SEC filing.

ASC 230-10-45-3 prohibits reporting an amount of cash flow per share. Question 102.05 in the Compliance and Disclosure Interpretations (C&DIs) regarding non-GAAP financial measures published by the SEC's Division of Corporation Finance[28] also prohibits non-GAAP liquidity measures that measure cash generated on a per-share basis. However, it does not expressly prohibit other non-GAAP EPS measures, consistent with Accounting Series Release (ASR) 142. ASR 142 concludes that "per share data other than that relating to net income, net assets and dividends should be avoided in reporting financial results." ASR 142 specifically questioned the relevance of per share measurements related to "… sales, current assets, funds flow, total assets, cash …" and other financial statement amounts that logically do not relate to the common shareholder without adjustment. Accordingly, registrants must limit disclosures of per-share measures to those that are meaningful from an operating viewpoint (i.e., those per-share measures involving earnings and common shareholders' equity).

[28] See https://www.sec.gov/corpfin/non-gaap-financial-measures.

When a registrant discloses a non-GAAP per-share measure outside the financial statements, the registrant must explain the additional purposes, if any, that the measure is used by management and in what way it provides meaningful information to investors. The registrant also must provide a reconciliation of the non-GAAP per-share measure to GAAP EPS. Registrants must present per-share non-GAAP measures with equal or greater prominence given to the GAAP measure.

### How we see it

Non-GAAP financial measures have recently been the most frequent source of SEC staff comments. The SEC staff continues to focus on whether non-GAAP financial measures reported by registrants comply with Item 10(e) of Regulation S-K and the SEC staff's C&DIs on this topic, including whether certain performance measures should have been identified as non-GAAP measures and whether identified non-GAAP measures are presented with the most directly comparable GAAP financial measure at the appropriate prominence level. In addition, the SEC staff has continued to question whether a registrant presented a non-GAAP measure that employed an individually tailored accounting principle that may be misleading.

Most of the SEC staff comments have focused on registrants' use of non-GAAP measures in earnings releases and SEC filings. However, the SEC staff also reviews other communications (e.g., websites, investor presentations) that may contain non-GAAP measures.

For further discussion, refer to our Technical Line, ***Navigating the requirements for non-GAAP financial measures***.

## 7.2 Disclosure

## 7.2.1 General disclosures (updated September 2024)

### FASB amendment

In October 2023, the FASB issued ASU 2023-06 to incorporate several SEC disclosure requirements into US GAAP, in response to a request from the SEC. The ASU potentially adds interim and annual disclosure requirements to a variety of topics in the Codification, including those focusing on EPS. Specifically, in ASC 260, the ASU would (1) clarify in ASC 260-10-50-1 that certain disclosures should be made during interim periods, (2) add a requirement in ASC 260-10-50-1(d) to disclose the methods used in the diluted EPS computation for each dilutive security (e.g., treasury stock method, if-converted method) and (3) amend Example 2 from ASC 260 (see Appendix E) to show the disclosure of the methods used in the diluted EPS computation.

However, it is important to note that these amendments will only become effective upon the removal of the related SEC requirements. If the SEC does not act to remove its related requirements by 30 June 2027, any related FASB amendments will be removed from the Codification and will not be effective for any entities. Readers should monitor this project for developments.

For entities subject to SEC disclosure requirements and those "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," the guidance will be effective upon the removal of the related SEC requirement. Early adoption is not permitted for these entities. For all other entities, the effective date will be two years later, and early adoption is permitted.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Disclosure*

*General*

***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

***260-10-50-1***

For each period for which an income statement is presented, including interim periods, 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.

d. 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**).

*260-10-50-1A*

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.)

*260-10-50-2*

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.

*Master Limited Partnerships*

*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.

For each period a statement of operations is presented, the following disclosures, among others, are required by ASC 260:

- A reconciliation of the numerator (earnings) and denominator (shares) of the basic and diluted per-share computations for income from continuing operations. The reconciliation should include the individual income and share effects of all securities that affect EPS.
- The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
- Securities (including those issuable pursuant to contingent stock agreements) that potentially could 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 periods presented (e.g., out-of-the-money options). Full disclosure of the terms and conditions of these securities is required even if they are not included in diluted EPS in the current period.

For the latest period in which a statement of operations is presented, an entity must describe any transaction that occurs after the end of the most recent reporting period but before issuance of the financial statements that would have materially changed 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 reporting period. ASC 260-10-50-2 notes that examples of transactions that may require these disclosures include (1) the issuance or acquisition of common shares, (2) the issuance of warrants, options or convertible securities, (3) the resolution of a contingency pursuant to a contingent stock agreement, and (4) the conversion or exercise of potential common shares outstanding at the end of the period into common shares.

An entity that has multiple classes of common stock should provide the disclosures required by ASC 260-10-50-1 and 50-2 separately for each class. For securities that participate in dividends with common stockholders, the participation rights of securities may be required to be disclosed in accordance with the provisions of ASC 505-10 regardless of whether undistributed earnings are allocated to the participating security (see section 5.3.1).

In addition, see section 5.5.2.3 for discussions on the required disclosures of a dropdown transaction associated with an MLP.

The following example provides an illustration of ASC 260's disclosure guidance (also see Example 2 from ASC 260 in Appendix E):

**Illustration 7-3: Disclosure**

The following is an illustration of the reconciliation of the numerators and denominators of the basic and diluted EPS computations and other related disclosures required by ASC 260:

*Note X — Earnings per share*

The following table sets forth the computation of basic and diluted EPS:

| | **20X3** | **20X2** | **20X1** |
|---|---|---|---|
| **Numerator:** | | | |
| Net income* | $ 4,500,000 | $ (2,000,000) | $ 14,000,000 |
| Preferred stock dividends | (30,000) | (30,000) | (30,000) |
| Numerator for basic EPS — income available to common stockholders (A) | 4,470,000 | (2,030,000) | 13,970,000 |
| Effect of dilutive securities: | | | |
| Preferred stock dividends | 30,000 | - | 30,000 |
| 2% convertible debentures** | 200,000 | - | 200,000 |
| | 230,000 | - | 230,000 |
| Numerator for diluted EPS — income available to common stockholders after assumed conversions (C) | $ 4,700,000 | $ (2,030,000) | $ 14,200,000 |
| **Denominator:** | | | |
| Denominator for basic EPS — weighted average shares (B) | 3,990,666 | 3,874,454 | 3,632,962 |
| Effect of dilutive securities: | | | |
| Employee stock options | 57,692 | - | 42,858 |
| Warrants*** | 38,462 | - | 71,429 |
| Contingent stock — acquisition | - | - | 20,000 |
| Convertible preferred stock | 600,000 | - | 600,000 |
| 2% convertible debentures | 300,000 | - | 300,000 |
| Dilutive potential common shares | 996,154 | - | 1,034,287 |
| Denominator for diluted EPS — adjusted weighted average shares and assumed conversions (D) | 4,986,820 | 3,874,454 | 4,667,249 |
| Basic EPS (A / B) | $ 1.12 | $ (0.52) | $ 3.85 |
| Diluted EPS (C / D) | $ 0.94 | $ (0.52) | $ 3.04 |

* The requirement in ASC 260-10-50-1(a) is to reconcile income from continuing operations. This example assumes there are no discontinued operations and no noncontrolling interests.

** For simplicity of this illustration, the income tax effect has been ignored.

*** Assume, for purposes of this example, that the warrants are equity-classified (i.e., no numerator adjustment required).

In the second quarter of 20X0, the Company issued 600,000 shares of convertible preferred stock. The annual dividend on each share of convertible preferred stock is $0.05 payable at the end of the year. Each share is convertible into one share of common stock. No preferred shares were converted to common stock in 20X3, 20X2 or 20X1.

In the last quarter of 20X0, the Company issued 2% debentures with a principal amount of $10 million due in 20 years. The par value is $1,000. Interest is payable semiannually on 1 March and 1 September. Each $1,000 debenture is convertible into 30 shares of common stock. No debentures were converted during 20X3, 20X2 or 20X1.

Warrants to purchase 500,000 shares of common stock at $60 per share for a period of five years were issued on 1 January 20X1. No warrants were exercised during 20X3, 20X2 or 20X1.

Employee stock options to purchase 250,000 and 150,000 shares of common stock were excluded from the calculation during 20X3 and 20X1, respectively, because the effect would be antidilutive.

The following potential common shares were excluded from diluted EPS in 20X2 because the effect would be antidilutive: 600,000 related to convertible preferred stock, 300,000 related to the Company's 2% convertible debentures, 500,000 for outstanding warrants to purchase the Company's stock and 200,000 outstanding employee stock options.

Under the ABC Company purchase agreement, if average net income over the four-year period ending 31 December 20X4 exceeds $10 million, the former stockholders of ABC Company would be entitled to receive 20,000 additional shares of common stock. The 20,000 additional shares are not included in the computation of diluted EPS in 20X3 or 20X2 because the average earnings declined below $10 million.

The following example provides an illustration of ASC 260's disclosure guidance when the two-class method is applied to calculate EPS because the entity has issued participating securities (see section 5). It does not depict an entity that applies the two-class method because it has multiple classes of common stock. This example addresses the reconciliation of the numerators and denominators for basic and diluted EPS required by ASC 260-10-50-1(a) and may not address certain other disclosure requirements of ASC 260. For example, ASC 260-10-55-24 says that the participation rights of participating securities may be required to be disclosed under ASC 505-10, regardless of whether undistributed earnings are allocated to the participating security.

**Illustration 7-4: Disclosure example when the two-class method is applied**

The following is an illustration of the reconciliation of the numerators and denominators of the basic and diluted EPS computations assuming the entity has participating share-based payment awards and is applying the two-class method to calculate EPS. The two-class method is applied in the calculation of diluted EPS because it is more dilutive than the treasury stock method. This example serves as an illustration only, and other methods for presenting the effect of distributed and undistributed earnings to participating securities may be acceptable. For simplicity, only 20X3 has been presented. See Illustration 7-3 above for other related disclosures required by ASC 260. The amounts in the example disclosure below are assumed for the purpose of this illustration.

*Note X — EPS*

The following table sets forth the computation of basic and diluted EPS:

| | 20X3 |
|---|---|
| **Numerator:** | |
| Net income | $ 4,500,000 |
| Convertible preferred stock dividends | (30,000) |
| Allocation of earnings to participating securities | (100,000) |
| Numerator for basic EPS — income available to common stockholders (A) | $ 4,370,000 |
| Effect of dilutive securities: | |
| Add back convertible preferred stock dividends | 30,000 |
| Add back allocation of earnings to participating securities | 100,000 |
| Reallocation of earnings to participating securities considering potentially dilutive securities | (86,000) |
| Numerator for diluted EPS — income available to common stockholders after assumed conversions (C) | $ 4,414,000 |
| **Denominator:** | |
| Denominator for basic EPS — weighted average shares (B) | 3,990,666 |
| Effect of dilutive securities: | |
| Nonparticipating warrants | 50,000 |
| Convertible preferred stock | 600,000 |
| Denominator for diluted EPS — adjusted weighted average shares (D) | 4,640,666 |
| Basic EPS (A / B) | $ 1.10 |
| Diluted EPS (C / D) | $ 0.95 |

## 7.2.2 Disclosure of the effects of ESOPs

**Excerpt from Accounting Standards Codification**

Compensation — Stock Compensation — Employee Stock Ownership Plans

*Disclosure*

*General*

*718-40-50-1 [Selected excerpts]*

b. A description of the accounting policies followed for employee stock ownership plan transactions, including the method of measuring compensation, the classification of dividends on employee stock ownership plan shares, and the treatment of employee stock ownership plan shares for earnings per share (EPS) computations. If the employer has both old employee stock ownership plan shares for which it does not adopt the guidance in this Subtopic and new employee stock ownership plan shares for which the guidance in this Subtopic is required, the accounting policies for both blocks of shares shall be described.

g. The amount and treatment in the EPS computation of the tax benefit related to dividends paid to any employee stock ownership plan, if material.

ASC 718-40-50-1 requires certain disclosures for ESOPs as shown above. For further discussion of the accounting for ESOPs, including EPS considerations, see section 4.5.1.

## 7.2.3 Differences between net income and income available to common shareholders

**Excerpt from Accounting Standards Codification**

Income Statement — Reporting Comprehensive Income — Overall

*SEC Materials*

*SAB Topic 6.B, Accounting Series Release 280—General Revision of Regulation S-X: Income or Loss Applicable to Common Stock*

*220-10-S99-5*

The following is the text of SAB Topic 6.B, Accounting Series Release 280—General Revision Of Regulation S-X: Income Or Loss Applicable To Common Stock.

Facts: A registrant has various classes of preferred stock. Dividends on those preferred stocks and accretions of their carrying amounts cause income applicable to common stock to be less than reported net income.

Question: In ASR 280, the Commission stated that although it had determined not to mandate presentation of income or loss applicable to common stock in all cases, it believes that disclosure of that amount is of value in certain situations. In what situations should the amount be reported, where should it be reported, and how should it be computed?

Interpretive Response: Income or loss applicable to common stock should be reported on the face of the income statement[FN1] when it is materially different in quantitative terms from reported net income or loss[FN2] or when it is indicative of significant trends or other qualitative considerations. The amount to be reported should be computed for each period as net income or loss less: (a) dividends on preferred stock, including undeclared or unpaid dividends if cumulative; and (b) periodic increases in the carrying amounts of instruments reported as redeemable preferred stock (as discussed in Topic 3.C) or increasing rate preferred stock (as discussed in Topic 5.Q).

FN1 When a registrant reports net income and total comprehensive income in one continuous financial statement, the registrant must continue to follow the guidance set forth in the SAB Topic. One approach may be to provide a separate reconciliation of net income to income available to common stock below comprehensive income reported on a statement of income and comprehensive income.

FN2 The assessment of materiality is the responsibility of each registrant. However, absent concerns about trends or other qualitative considerations, the staff generally will not insist on the reporting of income or loss applicable to common stock if the amount differs from net income or loss by less than ten percent.

The SEC requires that income or loss available to common stockholders (e.g., the numerator of the EPS calculation) be reported on the face of the statement of operations when it is materially different in quantitative terms from reported net income or loss or when it is indicative of significant trends or other qualitative considerations. While the guidance notes that the materiality assessment is the registrant's responsibility, the staff generally will not require presentation on the face (absent concerns about trends or other qualitative considerations) if the difference is less than 10%.

Regardless of whether the difference meets the SEC requirement for income or loss available to common stockholders to be disclosed on the face of the statement of operations, an entity would still be required to disclose a reconciliation of the EPS numerator in accordance with ASC 260-10-50-1(a), as discussed in section 7.2.1.

Income or loss available to common stockholders may differ from reported net income or loss for a variety of reasons (e.g., preferred stock dividends, changes in the carrying amount of certain redeemable securities). See section 3.2 for a summary of potential adjustments to net income to calculate income available to common stockholders.

### 7.2.4 Other SEC disclosure requirements (updated September 2024)

SEC Regulation S-X, Rule 10-01(b)(2) (and ASC 270-10-S99-1(b)(2)) state that SEC registrants should disclose, in interim financial statements, the basis of the EPS computation and the number of shares used in the computation. These disclosure requirements may be deleted by the SEC and moved to the Codification as discussed in section 7.2.1. If ASU 2023-06 is declared effective by the FASB, these disclosure requirements would be applicable to non-SEC registrants for the first time. Readers should monitor this project for developments.

In addition, as further discussed in our SEC Financial Reporting Series publication, *SEC annual reports — Form 10-K*, when there is one or more retrospective changes to the statements of comprehensive income for any of the quarters within the most recent two fiscal years that individually or in the aggregate are material, Item 302(a) of Regulation S-K requires registrants to provide an explanation of the reasons for the changes and disclose, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income and EPS reflecting the changes.

## 7.3 Restatement of EPS data

The following sections provide guidance on the restatement of EPS data when certain transactions or events, including stock dividends and stock splits, rights issues, prior period adjustments or a reverse acquisition have occurred.

### 7.3.1 Stock dividends or stock splits (updated August 2023)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Implementation Guidance and Illustrations***

***Restatement of EPS Data***

***Stock Dividends or Stock Splits***

***260-10-55-12***

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.

If the number of common shares outstanding increases as a result of a stock dividend or stock split, or decreases as a result of a reverse stock split, an entity should adjust the computations of basic and diluted EPS retroactively for all periods presented to reflect the 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, the per-share computations for those and any prior period financial statements presented should be based on the new number of shares. If per-share computations reflect such changes in the number of shares, ASC 260-10-55-12 requires disclosure of that fact. SEC filers, as required by SAB Topic 4.C (codified in ASC 505-10-S99-4), are required to "disclose the retroactive treatment, explain the change made and state the date the change become effective."

We believe that stock splits, reverse stock splits or stock dividends generally "occur" when the trading price of the shares has been adjusted to reflect the effects of such events (i.e., the event is effective). If a stock split, reverse stock split or stock dividend has been declared but is not effective at the date the financial statements are issued, companies should consider the disclosure requirements in ASC 855-10-50-2 through 50-3 with respect to nonrecognized subsequent events. See Question 11 in section S3.4.4 of our Accounting Manual, *Subsequent Events,* for further discussion.

### 7.3.1.1 Accounting for distributions to shareholders with components of stock and cash

**Excerpt from Accounting Standards Codification**

Equity — Stock Dividends and Stock Splits

*Scope and Scope Exceptions*

*Entities*

*505-20-15-1*

The guidance in this Subtopic applies to all entities that are corporations.

*Transactions*

*505-20-15-2*

The guidance in this Subtopic applies to all **stock dividends** and stock splits, with specific exceptions noted in paragraphs 505-20-15-3 through 15-3A.

*505-20-15-3*

The guidance in this Subtopic does not apply to the accounting for a distribution or issuance to shareholders of any of the following:

a. Shares of another corporation held as an investment

b. Shares of a different class

c. Rights to subscribe for additional shares

d. Shares of the same class in cases in which each shareholder is given an election to receive cash or shares.

*505-20-15-3A*

Item (d) in the preceding paragraph includes, but is not limited to, a distribution having both of the following characteristics:

a. The shareholder has the ability to elect to receive the shareholder's entire distribution in cash or shares of equivalent value.

b. There is a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate.

For guidance on recognition of an entity's commitment to make a distribution described in the preceding paragraph, see paragraph 480-10-25-14. For guidance on computation of diluted EPS of an entity's commitment to make such a distribution, see the guidance in paragraphs 260-10-45-45 through 45-47.

*Glossary*

*505-20*

*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.

A distribution that contains components of cash and stock and allows shareholders to select their preferred form of distribution should be treated as a stock issuance. This is based on the guidance in ASC 505 that states that a distribution of stock is considered a stock dividend only to the extent that all shareholders receive a proportionate distribution of stock such that their ownership interests after the distribution remain unchanged. Therefore, for EPS computation purposes, the stock portion of a distribution that contains components of cash and stock and allows shareholders to select their preferred form of distribution is reflected in EPS prospectively, consistent with the treatment of other new share issuances. It is not reflected retroactively as would be the case for a stock dividend (see section 7.3.1).

ASC 505-20-15-3A clarifies that distributions to shareholders with components of stock and cash when there is a potential limitation on the amount of cash to be distributed are not subject to the stock dividend guidance. ASC 505-20-15-3A also includes a reminder that an unconditional obligation that the issuer must or may settle by delivering a variable number of shares (i.e., the distribution) or cash with a fixed monetary amount should be considered a liability pursuant to ASC 480-10 and would be included in dilutive EPS pursuant to the guidance on contracts that may be settled in stock or cash in ASC 260-10-45-45 through 45-47 (see section 4.9 before the adoption of ASU 2020-06 or section 4.9A after the adoption of ASU 2020-06) until the liability is settled.

While these dividend structures are most common among Real Estate Investment Trusts (REITs) due to their distribution requirements under US tax regulations, the guidance is not limited to REITs. This guidance also applies to other entities that make similar distributions. REITs are required to distribute 90% of their taxable income in accordance with US tax regulations. In certain circumstances, REITs may satisfy these distribution requirements in cash and stock. Shareholders elect the form of their distribution, subject to a minimum (and generally a maximum) amount of the distribution to be paid in cash.

In a related issue, we believe that distributions that contain components of cash and stock and allow shareholders to select their preferred form of distribution should be considered in two-class method computations as distributions (i.e., reductions to net income in computing undistributed income) to securities that participate with common stock (see section 5). However, because these distributions are not considered stock dividends, our guidance in section 5.3.4 on equity restructurings would not be applicable.

## 7.3.2 Rights issues (updated September 2024)

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

*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.

*Implementation Guidance and Illustrations*

*Restatement of EPS Data*

*Rights Issues*

*260-10-55-13*

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.

*260-10-55-14*

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.

A rights issue is defined in ASC 260 as "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." 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 (see section 7.3.1). If a rights issue contains a bonus element and the rights issue is offered to all existing stockholders, basic and diluted EPS should 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, these provisions are not applicable until that contingency is resolved.

In retroactively adjusting EPS for prior periods, ASC 260-10-55-14 requires the number of common shares used in computing basic and diluted EPS for all periods prior to the rights issue to be the number of common shares outstanding immediately prior to the issue multiplied by the following adjustment 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.

However, it is not clear whether that guidance requires the adjusted denominator calculated prior to the rights issue to be used as the denominator in all prior period EPS calculations or whether the number of common shares originally used in each of the prior period EPS calculations should be multiplied by the adjustment factor in order to retroactively adjust EPS. We believe the guidance is intended to require the latter; that is, to adjust the number of common shares outstanding used in each of the prior period basic and diluted EPS calculations by the adjustment factor.

## How we see it

Because the guidance in ASC 260-10-55-13 says that the bonus element of a rights issue is somewhat similar to a stock dividend, we believe an entity should also consider the guidance in ASC 260-10-55-12 on stock dividends (see section 7.3.1) when accounting for noncontingent rights issues offered to all existing stockholders. This would include retrospectively restating any prior periods presented for a rights issue that occurs after the close of the period but before the financial statements are issued or are available to be issued and disclosing whether any per-share amounts reflect such changes.

ASC 260 includes an example below illustrating how to calculate the number of shares to include in the denominator of the EPS calculation for a rights issue that contains a bonus element.

### Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 5: Rights Issues*

*260-10-55-60*

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.

*260-10-55-61*

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 x 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.

## 7.3.3 Prior-period adjustments

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

***Implementation Guidance and Illustrations***

***Restatement of EPS Data***

***Prior-Period Adjustments***

*260-10-55-15*

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.

*260-10-55-16*

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.

In certain situations, authoritative literature requires restatement of the results of operations of a prior period (e.g., an accounting change the FASB requires to be made retroactively). Additionally, the correction of an error in the financial statements may require restatement of operating results of prior periods. In those instances, EPS data for the prior period or periods should be restated. The effect of the restatement, expressed in per-share terms, should be disclosed in the period of restatement. Also see our FRD, ***Accounting changes and error corrections***, which summarizes ASC 250 accounting and reporting requirements for accounting changes, including a change in accounting principle, and correction of errors in previously issued financial statements.

Restated EPS amounts are computed as if the restated income or loss had been reported originally in the prior period(s). Accordingly, it is possible that 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 ASC 260-10-45-18 (see section 4.2) and vice versa. 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. Further, if the numerator of the basic and diluted EPS calculations is affected, EPS amounts under the two-class method would also need to be recalculated.

Subsequent events other than the restatement of earnings are not considered in the restated computation (e.g., a contingency related to contingent shares is resolved in a subsequent period and the resolution was not consistent with the treatment of the previously reported EPS amounts; options were out-of-the-money during the restated year but subsequently were exercised when the market price increased).

### 7.3.4 Reverse acquisitions

**Excerpt from Accounting Standards Codification**

Business Combinations — Overall

*Glossary*

*805-10-20*

***Reverse Acquisition***

An acquisition in which the entity that issues securities (the legal acquirer) is identified as the **acquiree** for accounting purposes based on the guidance in paragraphs 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the **acquirer** for accounting purposes for the transaction to be considered a reverse acquisition.

For reverse acquisitions, EPS is required to be retrospectively adjusted for the legal acquirer since the acquisition represents a change in capital structure. That is, the reverse acquisition is similar to a stock split (see section 7.3.1). The guidance to compute EPS in a reverse acquisition is in ASC 805-40-45-3 through 45-5. Refer to section 3.2.2.2.4.1 of our FRD, ***Business combinations***, for more information.

However, as discussed in section 3.3.3, when common shares are issued in connection with the acquisition of a business in a transaction that is accounted for as a business combination pursuant to ASC 805, EPS should not be retrospectively adjusted.

# A Glossary

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Glossary*

*260-10-20*

*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*

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.

**Pending Content:**

**Transition Date:** *(P) December 16, 2024; (N) December 16, 2025* **| Transition Guidance:** 105-10-65-9

Cash, evidence of an ownership interest in an entity, or a contract that both:

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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. Some contractual rights (contractual obligations) that are financial instruments may not be recognized 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 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*** [EY Note: Per the ASC Master Glossary, this definition is applicable to ASC 260 and 505]

The evidence of debt or ownership or a related right. It includes options and warrants as well as debt and stock.

***Security*** [EY Note: Per the ASC Master Glossary, this definition is applicable to ASC 320, 321, 470, 815, 860, 952 and 958]

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.

***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.

Distinguishing Liabilities from Equity — Overall

*Glossary*

*480-10-20 [Selected excerpts]*

*Issuer's Equity Shares*

The equity shares of any entity whose financial statements are included in the consolidated financial statements.

*Physical Settlement*

A form of settling a financial instrument under which both of the following conditions are met:

a. The party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller.

b. The seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.

Compensation — Stock Compensation

*Glossary*

*718-10-20 [Selected excerpts]*

*Award*

The collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single grantee or to a group of grantees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. References to an award also apply to a portion of an award.

*Market Condition*

A condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of either of the following:

a. A specified price of the issuer’s shares or a specified amount of intrinsic value indexed solely to the issuer’s shares

b. A specified price of the issuer’s shares in terms of a similar (or index of similar) equity security (securities). The term similar as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

*Nonvested Shares*

Shares that an entity has not yet issued because the agreed-upon consideration, such as the delivery of specified goods or services and any other conditions necessary to earn the right to benefit from the instruments, has not yet been satisfied. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

*Vest*

To earn the rights to. A share-based payment award becomes vested at the date that the grantee’s right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

The stated vesting provisions of an award often establish the employee’s requisite service period or the nonemployee’s vesting period, and an award that has reached the end of the applicable period is vested. However, as indicated in the definition of requisite service period and equally applicable to a nonemployee’s vesting period, the stated vesting period may differ from those periods in certain circumstances. Thus, the more precise terms would be options, shares, or awards for which the requisite good has been delivered or service has been rendered and the end of the employee’s requisite service period or the nonemployee’s vesting period.

Compensation — Stock Compensation — Employee Stock Ownership Plans

*Glossary*

*718-40-20 [Selected excerpts]*

*Allocated Shares*

Allocated shares are shares in an employee stock ownership plan trust that have been assigned to individual participant accounts based on a known formula. Internal Revenue Service (IRS) rules require allocations to be nondiscriminatory generally based on compensation, length of service, or a combination of both. For any particular participant such shares may be vested, unvested, or partially vested.

*Committed-to-Be-Released Shares*

Committed-to-be-released shares are shares that, although not legally released, will be released by a future scheduled and committed debt service payment and will be allocated to employees for service rendered in the current accounting period. The period of employee service to which shares relate is generally defined in the employee stock ownership plan documents. Shares are legally released from suspense and from serving as collateral for employee stock ownership plan debt as a result of payment of debt service. Those shares are required to be allocated to participant accounts as of the end of the employee stock ownership plan's fiscal year. Formulas used to determine the number of shares released can be based on either of the following:

a. The ratio of the current principal amount to the total original principal amount (in which case unearned employee stock ownership plan shares and debt balance will move in tandem)

b. The ratio of the current principal plus interest amount to the total original principal plus interest to be paid.

Shares are released more rapidly under the second method than under the first. Tax law permits the first method only if the employee stock ownership plan debt meets certain criteria.

*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.

*Fair Value*

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

*Suspense Shares*

The shares initially held by the employee stock ownership plan in a suspense account are called suspense shares. Suspense shares are shares that have not been released, committed to be released, or allocated to participant accounts. Suspense shares generally collateralize employee stock ownership plan debt.

Business Combinations

*Glossary*

*805-10-20 [Selected excerpts]*

*Acquiree*

The **business** or **businesses** that the **acquirer** obtains control of in a **business combination**. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an **acquisition by a not-for-profit entity**.

*Acquirer*

The entity that obtains control of the **acquiree**. However, in a **business combination** in which a **variable interest entity** (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

# B Abbreviations used in this publication

| *Abbreviation* | *FASB Accounting Standards Codification* |
|---|---|
| ASC 205-20 | FASB ASC Topic 205-20, *Presentation of Financial Statements — Discontinued Operations* |
| ASC 220 | FASB ASC Topic 220, *Income Statement — Reporting Comprehensive Income* |
| ASC 230 | FASB ASC Topic 230, *Statement of Cash Flows* |
| ASC 250 | FASB ASC Topic 250, *Accounting Changes and Errors Corrections* |
| ASC 260 | FASB ASC Topic 260, *Earnings Per Share* |
| ASC 270 | FASB ASC Topic 270, *Interim Reporting* |
| ASC 320 | FASB ASC Topic 320, *Investments — Debt Securities* |
| ASC 321 | FASB ASC Topic 321, *Investments — Equity Securities* |
| ASC 470 | FASB ASC Topic 470, *Debt* |
| ASC 470-20 | FASB ASC Topic 470-20, *Debt — Debt with Conversion and Other Options* |
| ASC 480 | FASB ASC Topic 480, *Distinguishing Liabilities from Equity* |
| ASC 505 | FASB ASC Topic 505, *Equity* |
| ASC 505-20 | FASB ASC Topic 505-20, *Equity — Stock Dividends and Stock Splits* |
| ASC 505-30 | FASB ASC Topic 505-30, *Equity — Treasury Stock* |
| ASC 710 | FASB ASC Topic 710, *Compensation — General* |
| ASC 718 | FASB ASC Topic 718, *Compensation — Stock Compensation* |
| ASC 718-40 | FASB ASC Topic 718-40, *Compensation — Stock Compensation — Employee Stock Ownership Plans* |
| ASC 718-50 | FASB ASC Topic 718-50, *Compensation — Stock Compensation — Employee Share Purchase Plans* |
| ASC 718-740 | FASB ASC Topic 718-740, *Compensation — Stock Compensation — Income Taxes* |
| ASC 805 | FASB ASC Topic 805, *Business Combinations* |
| ASC 805-50 | FASB ASC Topic 805-50, *Business Combinations — Related Issues* |
| ASC 810 | FASB ASC Topic 810, *Consolidation* |
| ASC 815 | FASB ASC Topic 815, *Derivatives and Hedging* |
| ASC 815-40 | FASB ASC Topic 815-40, *Derivatives and Hedging — Contract in Entity's Own Equity* |
| ASC 825 | FASB ASC Topic 825, *Financial Instruments* |
| ASC 855 | FASB ASC Topic 855, *Subsequent Events* |
| ASC 860 | FASB ASC Topic 860, *Transfers and Servicing* |
| ASC 946 | FASB ASC Topic 946, *Financial Services — Investment Companies* |
| ASC 952 | FASB ASC Topic 952, *Franchisors* |
| ASC 958 | FASB ASC Topic 958, *Not-for-Profit Entities* |

| *Abbreviation* | *Other authoritative standards* |
|---|---|
| ASU 2020-06 | Accounting Standards Update No. 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* |
| ASU 2020-10 | Accounting Standards Update No. 2020-10, *Codification Improvements* |
| ASU 2021-04 | Accounting Standards Update No. 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* |
| ASU 2023-06 | Accounting Standards Update No. 2023-06, *Disclosure Improvements — Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative* |
| ASR 142 | Accounting Series Release No. 142, *Reporting Cash Flow and Other Related Data* |
| ASR 268 | Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* |
| ASR 280 | Accounting Series Release No. 280, *General Revision Of Regulation S-X: Income Or Loss Applicable To Common Stock* |
| SAB Topic 1.B.3 | SEC Staff Accounting Bulletin Topic 1.B.3, *Allocation of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity — Other matters* |
| SAB Topic 3.A | SEC Staff Accounting Bulletin Topic 3.A, *Convertible Securities* |
| SAB Topic 3.C | SEC Staff Accounting Bulletin Topic 3.C, *Redeemable Preferred Stock* |
| SAB Topic 4.C | SEC Staff Accounting Bulletin Topic 4.C, *Change in Capital Structure* |
| SAB Topic 4.D | SEC Staff Accounting Bulletin Topic 4.D, *Earnings Per Share Computations In An Initial Public Offering* |
| SAB Topic 5.A | SEC Staff Accounting Bulletin Topic 5.A, *Expenses of Offering* |
| SAB Topic 5.Q | SEC Staff Accounting Bulletin Topic 5.Q, *Increasing Rate Preferred Stock* |
| SAB Topic 6.B | SEC Staff Accounting Bulletin Topic 6.B, *Accounting Series Release 280 — General Revision Of Regulation S-X: Income Or Loss Applicable To Common Stock* |
| Rule 5-02 | SEC Regulation S-X Rule 5-02, *Commercial and Industrial Companies — Balance Sheets* |
| Rule 10-01 | SEC Regulation S-X Rule 10-01, *Interim financial statements* |
| Rule 11-02 | SEC Regulation S-X Rule 11-02, *Pro Forma Financial Information — Preparation requirements* |

| *Abbreviation* | *Non-authoritative standards* |
|---|---|
| EITF D-98 | EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities* |
| EITF 09-1 | EITF Issue No. 09-1, *Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing* |
| EITF 90-19 | EITF Issue No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion* |
| FSP APB 14-1 | FASB Staff Position No. APB 14-1, *Accounting for Convertible Debt Instruments that May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)* |
| SOP 76-3 | AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans* |
| SOP 93-6 | AICPA Statement of Position 96-3, *Employers' Accounting for Employee Stock Ownership Plans* |
| Statement 128 | FASB Statement No. 128, *Earnings per Share* |

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| 260-10-45-45A | 4.9A | Contracts that may be settled in stock or cash (after adoption of ASU 2020-06) |
| 260-10-45-45A | 4.9.3A | Share-based payment awards that may be settled in stock or cash (after adoption ASU 2020-06) |
| 260-10-45-46 | 4.9 | Contracts that may be settled in stock or cash (before adoption of ASU 2020-06) |
| 260-10-45-46 | 4.9A | Contracts that may be settled in stock or cash (after adoption of ASU 2020-06) |
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| ASC paragraph | Section | |
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| 260-10-45-60A | 5.2 | Determining whether a security is a participating security |
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| 260-10-50-1A | 7.2.1 | General disclosures |
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| 260-10-50-3 | 5.5.2.3 | Allocation of earnings and losses prior to a dropdown |
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|---|---|---|
| 260-10-55-5 | 4.3.1 | Computing the average market price |
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| 260-10-55-7 | 4.3 | Options, warrants and their equivalents and the treasury stock method |
| 260-10-55-8 | 4.3 | Options, warrants and their equivalents and the treasury stock method |
| 260-10-55-9 | 4.3 | Options, warrants and their equivalents and the treasury stock method |
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| 260-10-55-28 | 5.3.1 | Allocation of undistributed earnings to a participating security |
| 260-10-55-29 | 5.3.1 | Allocation of undistributed earnings to a participating security |
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| 260-10-55-31 | 5.3.1 | Allocation of undistributed earnings to a participating security |
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| 260-10-55-33 | 4.9.3A | Share-based payment awards that may be settled in stock or cash (after adoption ASU 2020-06) |
| 260-10-55-34 | 4.9 | Contracts that may be settled in stock or cash (before adoption of ASU 2020-06) |

| ASC paragraph | Section | |
|---|---|---|
| 260-10-55-34 | 4.9A | Contracts that may be settled in stock or cash (after adoption of ASU 2020-06) |
| 260-10-55-36 | 4.9 | Contracts that may be settled in stock or cash (before adoption of ASU 2020-06) |
| 260-10-55-36 | 4.9A | Contracts that may be settled in stock or cash (after adoption of ASU 2020-06) |
| 260-10-55-36A | 4.9 | Contracts that may be settled in stock or cash (before adoption of ASU 2020-06) |
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| 505-10-50-3A | 3.2.3 | Effect of instruments with down round features on income available to common stockholders (before adoption of ASU 2020-06) |
| 505-10-50-3A | 3.2.3A | Effect of instruments with down round features on income available to common stockholders (after adoption of ASU 2020-06) |
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| ASC paragraph | Section | |
|---|---|---|
| 505-20-15-3A | 7.3.1.1 | Accounting for distributions to shareholders with components of stock and cash |
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| 505-30-25-6 | 5.2.3 | Accelerated share repurchase programs |
| 505-30-55-1 | 5.2.3 | Accelerated share repurchase programs |
| 505-30-55-2 | 5.2.3 | Accelerated share repurchase programs |
| 505-30-55-3 | 5.2.3 | Accelerated share repurchase programs |
| 505-30-55-4 | 5.2.3 | Accelerated share repurchase programs |
| 505-30-55-5 | 5.2.3 | Accelerated share repurchase programs |
| 505-30-55-6 | 5.2.3 | Accelerated share repurchase programs |
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| 718-40-05-4 | 4.5.1 | Employee stock ownership plans |
| 718-40-45-1 | 4.5.1 | Employee stock ownership plans |
| 718-40-45-2 | 4.5.1 | Employee stock ownership plans |
| 718-40-45-3 | 4.5.1 | Employee stock ownership plans |
| 718-40-45-4 | 4.5.1 | Employee stock ownership plans |
| 718-40-45-5 | 4.5.1 | Employee stock ownership plans |
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| 718-40-45-7 | 4.5.1 | Employee stock ownership plans |
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| 718-40-50-1 | 7.2.2 | Disclosure of the effects of ESOPs |
| 815-40-35-16 | 3.2.4 | Effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders |
| 815-40-35-17 | 3.2.4 | Effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders |
| 815-40-50-6 | 3.2.4 | Effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders |
| 815-40-55-49 | 3.2.4 | Effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders |
| 815-40-55-51 | 3.2.4 | Effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders |

# D Summary of important changes

## September 2024 version

### Section 3 Basic EPS

- Updated section 3.3.2 to add Question 3-1 to address the treatment of clawback provisions on the calculation of basic EPS.
- Updated section 3.3.2 to add Question 3-2 to address the effect of shares issued upon an early exercise of stock options on the calculation of basic EPS.

### Section 4 Diluted EPS

- Updated section 4.1 to add illustration 4-1 on calculating diluted EPS based on the most advantageous conversion rate or exercise price from the standpoint of the security holder.
- Updated section 4.2 to add Example 14 from ASC 260 on the use of income from continuing operations as the "control number" in determining whether potential common shares are dilutive or antidilutive when an entity reports discontinued operations.
- Updated section 4.3 to add Example 15 from ASC 260 on how to determine the number of incremental shares to add to the diluted EPS calculation using the treasury stock method for options, warrants and their equivalents.
- Updated section 4.3 to discuss whether a forward sale contract is antidilutive (and, therefore, should be excluded from the diluted EPS calculation) solely because it is out-of-the-money.
- Added section 4.4.3 on profits interests.
- Updated section 4.7.1 to address the effect of a non-market-price contingency in the diluted EPS calculation when it only accelerates the timing of a holder's ability to convert the instrument to common stock.
- Updated section 4.7.2 to add to the graphic how a contingently convertible instrument with either a market-price or a non-market-price contingency affects the diluted EPS calculation.
- Updated section 4.8 to enhance the graphic that summarizes the guidance on contingently issuable shares for diluted EPS by adding the requirements of ASC 260-10-45-48(a).
- Updated section 4.9A to clarify the application of the guidance in ASC 260 on contracts that may be settled in stock or cash to instruments that may be settled in cash or potential shares.
- Updated section 4.10 to discuss whether a forward purchase contract is antidilutive (and, therefore, should be excluded from the diluted EPS calculation) solely because it is out-of-the-money.
- Updated section 4.10 to discuss how the exception in ASC 260-10-45-35 and 45-70A related to a forward purchase contract on a fixed number of the issuer's shares that required physical settlement applies to a similar variable forward purchase contract with a fixed minimum.

### Section 6 Other matters

- Updated section 6.3 to discuss the need to consider whether partially paid shares and partially paid stock subscriptions are participating securities.

### Section 7 Presentation and disclosure

- Updated section 7.1 to include EPS presentation requirements for interim periods (from ASC 270) and for the two-class method (from ASC 260).
- Updated sections 7.2.1 and 7.2.4 for the issuance of ASU 2023-06.
- Updated section 7.2.1 to clarify that an entity that has multiple classes of common stock should provide the disclosures required by ASC 260-10-50-1 and 50-2 separately for each class.
- Updated section 7.3.2 to discuss whether an entity should also consider the guidance in ASC 260-10-55-12 on stock dividends when accounting for rights issues.

## August 2023 version

### Section 1 Overview

- Updated section 1.5 to remove discussion of ASU 2021-04 that has been fully adopted by all entities.

### Section 3 Basic EPS

- Updated section 3.2 to refer to the guidance in SAB Topic 5.Q on increasing rate preferred stock.
- Updated section 3.2.4 to remove references to before adoption of ASU 2021-04 because the standard has been fully adopted by all entities.
- Updated section 3.3.2 to discuss the treatment of prepaid forward sale contracts in basic EPS.

### Section 4 Diluted EPS

- Updated section 4.3 to further discuss the guidance in ASC 260-10-55-6 through 55-11 on the use of the treasury stock method in certain situations, primarily for options or warrants with specific conversion options.
- Updated section 4.3.2 to enhance our discussion of and add Illustration 4-5 on how to apply the treasury stock method in quarterly and year-to-date calculations.
- Updated section 4.4.1 to discuss how we believe modifications of share-based payment awards should be treated in the diluted EPS calculation.
- Updated section 4.4.2 to add Illustration 4-7 on share-based payments with performance and market conditions.
- Updated section 4.5.2 to add our view that entities can use the average market price for the period to compute the number of incremental shares issuable under an ESPP after the adoption of ASU 2020-06.
- Updated section 4.6 to include a graphic on other numerator adjustments that may need to be made under the if-converted method in order to adjust for any other changes in income or loss that would have resulted from the assumed conversion of the potential common shares as of the beginning of the period.

- Updated section 4.6.2 to enhance our discussion of how to apply the if-converted method in quarterly and year-to-date calculations and amended Illustration 4-9 to focus solely on the if-converted method (it previously included treasury stock method calculations, which are now included in Illustration 4-5 in section 4.3.2).
- Updated section 4.11 to discuss how the unit of account for purchased and written options that are part of a hedge strategy affects the inclusion of the options in the diluted EPS calculation.

### Section 5 Participating securities and the two-class method

- Updated section 5.1 for two important reminders regarding the requirement to use the two-class method when (1) multiple classes of common stock exist (even if they have the same EPS) and (2) participating securities exist (even if an entity has not paid or does not intend to pay dividends).
- Updated sections 5.3.1 and 5.3.2 for our view that the allocation of undistributed earnings and losses, respectively, under the two-class method is generally based on the weighted average number of common shares and participating securities outstanding for the period (i.e., not the number of shares or participating securities outstanding at the end of the period).

### Section 6 Other matters

- Updated section 6.6 and Illustration 6-5 to remove our interpretation of the applicability of SAB Topic 4.D to post-IPO filings because the SEC staff's Division of Corporation Finance Financial Reporting Manual states that SAB Topic 4.D is applicable to both IPO and subsequent filings.

### Section 7 Presentation and disclosure

- Updated sections 7.1 and 7.2.1 to remove references to before adoption of ASU 2020-10 because the standard has been fully adopted by all entities.
- Updated section 7.1 to discuss the guidance in ASC 220-20 that precludes the EPS effect of a material event or transaction that is of an unusual nature, or occurs infrequently (or both), from being presented on the face of the income statement.
- Updated section 7.3.1 to discuss disclosure requirements for SEC filers related to stock dividends or stock splits included in SAB Topic 4.C.

# E Additional examples from ASC 260

Example 1 should be read in conjunction with sections 3, 4 and 7 of this publication.

**Excerpt from Accounting Standards Codification**

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

***Example 1: Computation of Basic and Diluted EPS and Income Statement Presentation***

*260-10-55-38*

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.

*260-10-55-39*

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.

*260-10-55-40*

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 | 2/3 | 2,200,000 |
| *Issuance of common stock on March 1* | 100,000 | | |
| March 1-March 31 | 3,400,000 | 1/3 | 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 x $0.05

*260-10-55-41*

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 x $0.05

[b] ($10,000,000 x 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).

*260-10-55-42*

This 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 | 2/3 | 2,400,000 |
| *Conversion of preferred stock on June 1* | 500,000 | | |
| June 1-June 30 | 4,100,000 | 1/3 | 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 x $0.05

*260-10-55-43*

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 of 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 x $0.05

[(b)] $60 x 500,000 = $30,000,000; $30,000,000 ÷ $70 = 428,571; 500,000 - 428,571 = 71,429 shares OR [($70-$60) ÷ $70] x 500,000 shares = 71,429 shares

[(c)] (600,000 shares x 2/3) + (100,000 shares x 1/3)

*260-10-55-44*

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 | 2/3 | 2,733,333 |
| *Exercise of warrants on September 1* | 500,000 | | |
| September 1-September 30 | 4,600,000 | 1/3 | 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:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

*260-10-55-45*

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 of 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] x 500,000 = 77,465 shares; 77,465 x 2/3 = 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.)

*260-10-55-46*

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.)

*260-10-55-47*

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:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

*260-10-55-48*

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 of discontinued operations | | (2,000,000) |
| Net loss 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 x 3/12) + (51,643 shares x 3/12)

[(b)] (600,000 shares x 5/12) + (100,000 shares x 7/12)

[(c)] 200,000 shares x 3/12

*260-10-55-49*

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 |

*260-10-55-50*

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 |

Example 2 should be read in conjunction with Section 7 of this publication.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 2: EPS Disclosures*

*260-10-55-51*

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

*260-10-55-51*

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.

*260-10-55-52*

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 | |
| **Dilutive 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

*260-10-55-52*

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 | |
| **Dilutive EPS** | | | |
| Income available to common stockholders + assumed conversions | $ 7,560,000 | 4,380,767 | $ 1.73 |

Diluted EPS was computed using the treasury stock method for warrants and the if-converted method for convertible instruments. 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.

Example 9 should be read in conjunction with section 5 of this publication.

## Excerpt from Accounting Standards Codification

Earnings Per Share — Overall

*Implementation Guidance and Illustrations*

*Example 9: Participating Securities and the Two-Class Method*

*260-10-55-71*

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).

*260-10-55-72*

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*

*260-10-55-73*

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) ÷ [0.4(5,000) + 0.6(10,000)] x $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)] x $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***

***260-10-55-74***

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)] x $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)] x $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*

*260-10-55-75*

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)] x $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)] x $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*

*260-10-55-76A*

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.

*260-10-55-76B*

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.

*260-10-55-76C*

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 x $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 x $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) x $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) x $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.

*260-10-55-76D*

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.

# F List of examples included in ASC 260, and references in this publication

| Example | Paragraphs | Title | Section |
|---|---|---|---|
| Example 1 | 260-10-55-38 through 55-50 | Computation of Basic and Diluted EPS and Income Statement Presentation | Appendix E |
| Example 2 | 260-10-55-51 through 55-52 | EPS Disclosures | Appendix E |
| Example 3 | 260-10-55-53 through 55-56 | Contingently Issuable Shares | Section 4.8.5 |
| Example 4 | 260-10-55-57 through 55-59 | Antidilution Sequencing | Not included |
| Example 5 | 260-10-55-60 through 55-61 | Rights Issues | Section 7.3.2 |
| Example 6 | 260-10-55-62 through 55-63 | Two-Class Method | Not included |
| Example 7 | 260-10-55-64 through 55-67 | Securities of a Subsidiary — Computation of Basic and Diluted EPS | Section 6.1 |
| Example 8 | 260-10-55-68 through 55-70 | Application of the Treasury Stock Method to a Share-Based Payment Arrangement | Section 4.4.1.3 |
| Example 9 | 260-10-55-71 through 55-72 | Participating Securities and the Two-Class Method | |
| | 260-10-55-73 | Case A: Participating Convertible Preferred Stock | Section 5.3.3.1 and Appendix E |
| | 260-10-55-74 | Case B: Participating Convertible Debt Instrument | Appendix E |
| | 260-10-55-75 | Case C: Participating Warrants | Appendix E |
| | 260-10-55-76A through 55-76D | Case D: Participating Share-Based Payment Awards | Appendix E |
| Example 10 | N/A | Not used in ASC 260 | N/A |
| Example 11 | 260-10-55-78 through 55-80 | Computation of Basic and Diluted EPS for Two Examples of Contingently Convertible Instruments (before the adoption of ASU 2020-06) | |
| | 260-10-55-81 through 55-83 | Case A: Contingently Convertible Debt with a Market Price Trigger | Section 4.7.2 |
| | 260-10-55-84 through 55-84B | 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 | Section 4.9.1 |

| Example | Paragraphs | Title | Section |
|---|---|---|---|
| Example 11 | 260-10-55-78 through 55-80 | Computation of Basic and Diluted EPS for Three Examples of Contingently Convertible Instruments (after the adoption of ASU 2020-06) | |
| | 260-10-55-81 through 55-83 | Case A: Contingently Convertible Debt with a Market Price Trigger | Section 4.7.2 |
| | 260-10-55-84 through 55-84B | 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 | Section 4.9.1A |
| | 260-10-55-84C through 55-84E | Case C: Convertible Debt That the Principal and Conversion Premium Can Be Settled in Any Combination of Shares or Cash | Section 4.9.1A |
| Example 12 | 260-10-55-85 | Computing Year-to-Date Weighted-Average Shares Outstanding | |
| | 260-10-55-86 | Case A: Year-to-Date Loss | Section 4.3.2 |
| | 260-10-55-87 | Case B: Year-to-Date Income | Section 4.3.2 |
| Example 13 | 260-10-55-88 through 55-89 | Accelerated Share Repurchase Programs | Section 5.2.3 |
| Example 14 | 260-10-55-90 through 55-91 | Antidilutive Securities | Section 4.2 |
| Example 15 | 260-10-55-92 through 55-94 | Options, Warrants, and Their Equivalents | Section 4.3 |
| Example 16 | 260-10-55-95 through 55-97 | Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature | Sections 3.2.3 and 3.2.3A |

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SCORE no. BB1971
(Revised September 2024)

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