**Topic:** Computing Year-to-Date Diluted Earnings per Share under FASB Statement No. 128

**Dates Discussed:** July 23-24, 1997; November 20, 1997

An FASB representative announced that the FASB staff has received inquiries about how to compute year-to-date diluted earnings per share (EPS) (a) when a company has a year-to-date loss from continuing operations including one or more quarters with income from continuing operations and (b) 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.

Paragraph 46 of FASB Statement No. 128, *Earnings per Share,* states that in applying the treasury stock method in year-to-date computations, ". . . 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." Similar guidance is provided for contingent shares in footnote 18 of Statement 128.

However, Statement 128 includes a prohibition against antidilution. The no-antidilution rule in paragraph 13 states that "the computation of diluted EPS shall not assume conversion, exercise, or contingent issuance of securities that would have an antidilutive effect on earnings per share." Some have suggested that a conflict emerges between those two provisions when a period that is longer than three months has an overall loss but includes quarters with income. For periods with year-to-date income, some have suggested that the guidance in paragraph 46 contradicts the guidance in paragraph 11. Paragraph 11 states, in part, that "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*" (emphasis added).

In computing year-to-date diluted EPS, the staff believes that year-to-date income (or loss) from continuing operations should be the basis for determining whether or not dilutive potential common shares not included in one or more quarterly computations of diluted EPS should be included in the year-to-date computation.

Thus, (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 and (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.

The following examples illustrate 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, the example assumes that the stock price never changed). Example 1 addresses (a) above (the year-to-date loss issue), and Example 2 addresses (b) above (the year-to-date income issue).

**Computation of Quarterly and Year-to-Date EPS**
**Example 1**

| 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* | 20,000 | 0* |
| | | | | |
| Basic EPS | $ 0.50 | $ (1.50) | $ 0.50 | $ (2.00) |
| Diluted EPS | $ 0.42 | $ (1.50) | $ 0.42 | $ (2.00) |

| 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* | 0* | 0* |
| | | | | |
| Basic EPS | $ 0.50 | $ (1.00) | $ (0.50) | $ (2.50) |
| Diluted EPS | $ 0.42 | $ (1.00) | $ (0.50) | $ (2.50) |

_____

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

**Example 2**

| 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* | 0* | 20,000 | 20,000 |
| | | | | |
| Basic EPS | $(0.05) | $(0.05) | $1.10 | $2.00 |
| Diluted EPS | $(0.05) | $(0.05) | $0.92 | $1.67 |

| 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* | 0* | 20,000[+] | 20,000[‡] |
| | | | | |
| Basic EPS | $(0.05) | $(0.10) | $1.00 | $3.00 |
| Diluted EPS | $(0.05) | $(0.10) | $0.83 | $2.50 |

_____

*Zero shares included due to loss in the period.
[+]Nine-month computation: $(20 + 20 + 20) \div 3$
[‡]Full-year computation: $(20 + 20 + 20 + 20) \div 4$

**Note:** 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.