

# Financial Accounting Series

---

---

EXPOSURE DRAFT (Revised)

## Proposed Statement of Financial Accounting Standards

**Earnings per Share**

**an amendment of FASB Statement No. 128**

Revision of Exposure Draft  
Issued December 15, 2003

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Technical Director  
File Reference No. 1240-001

Comment Deadline: November 30, 2005



Financial Accounting Standards Board  
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by November 30, 2005. Interested parties should submit their comments by email to [director@fasb.org](mailto:director@fasb.org), File Reference 1240-001. Those without email may send their comments to the “Technical Director—File Reference 1240-001” at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB’s website and will be included in the project’s public record.

Any individual or organization may obtain one copy of this Exposure Draft without charge until November 30, 2005, on written request only. *Please ask for our Product Code No. E187.* For information on applicable prices for additional copies and copies requested after November 30, 2005, contact:

Order Department  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Copyright © 2005 by Financial Accounting Standards Board. All rights reserved. Permission is granted to make copies of this work provided that such copies are for personal or intraorganizational use only and are not sold or disseminated and provided further that each copy bears the following credit line: “Copyright © 2005 by Financial Accounting Standards Board. All rights reserved. Used by permission.”



**Financial Accounting Standards Board**  
of the Financial Accounting Foundation  
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

<p style="text-align: center;"><b>Notice for Recipients of This Exposure Draft</b></p>
--

This proposed Statement would amend FASB Statement No. 128, *Earnings per Share*, to clarify guidance for mandatorily convertible instruments, the treasury stock method, contracts that may be settled in cash or shares, and contingently issuable shares.

This proposed Statement is a revision of the December 2003 proposed Statement, *Earnings per Share*, which was issued as part of the Board's project on short-term international convergence. That proposed Statement would:

- a. Amend the computational guidance in Statement 128 for calculating the number of incremental shares included in diluted shares when applying the treasury stock method
- b. Eliminate the provision of Statement 128 that allows an entity to rebut the presumption that contracts that may be settled in either cash or shares will be settled in shares
- c. Require that shares that would be issued upon conversion of a mandatorily convertible instrument be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share (EPS) from the date when future conversion becomes mandatory.

During its redeliberations of the 2003 Exposure Draft, the Board affirmed each of the above proposed changes. The Board also decided during its redeliberations to propose additional changes to the requirements of Statement 128 that would:

- a. Further revise the computational guidance applicable to the treasury stock method to treat the carrying amount of an extinguished liability upon issuance of shares as assumed proceeds in the computation of incremental shares
- b. Eliminate the weighted-average computation for calculating contingently issuable shares and require that contingently issuable shares be included in diluted EPS from the beginning of the period that the conditions for issuance are satisfied, or the date of the contingent share arrangement, if later
- c. Define a mandatorily convertible instrument and clarify that shares that would be issued upon conversion of a mandatorily convertible instrument should be included in the computation of basic EPS whether the effect is dilutive or antidilutive
- d. Clarify that share settlement must be assumed (if dilutive) for the purpose of computing diluted EPS for an otherwise cash-settled instrument that contains a provision that requires or permits share settlement under certain circumstances.

Because the proposed change to the computational guidance applicable to the treasury stock method was deemed to be substantive, the Board decided to issue this revised Exposure Draft instead of proceeding directly with the issuance of a final Statement. This revised Exposure Draft is marked to indicate all of the proposed amendments to Statement 128. Shaded text shows amendments proposed in the 2003 Exposure Draft, with added text underscored and deleted text struck out. Unshaded text shows amendments proposed during redeliberations, with added text underscored and

deleted text struck out. Several paragraphs of unamended text from Statement 128 have been included to provide additional context for the amendments being presented—for example, paragraphs 8 and 9 of Statement 128 in the standards section of the proposed Statement provide context for the amendments to paragraph 10.

The Board invites comments on all matters in this proposed Statement, particularly on the issues discussed below. Respondents need not comment on that issue and are encouraged to comment on additional issues. Respondents need not repeat their comments that were submitted in response to the 2003 Exposure Draft, as those comments were considered by the Board during its redeliberations. It would be helpful if comments explain the reasons for the positions taken and include any alternatives the Board should consider.

### **Extinguishment of a Liability Is Assumed Proceeds**

*Issue 1:* This proposed Statement would require that in applying the treasury stock method to an instrument classified as a liability but potentially settled in shares, the carrying amount of an extinguished liability upon issuance of the shares should be included as assumed proceeds in the computation of incremental shares. Do you agree? If not, why? This provision would apply only to instruments subject to the treasury stock method and would not affect the EPS computation for instruments that are accounted for using the if-converted method under Statement 128. Do you agree? If not, why?

*Issue 2:* This proposed Statement would require that the amount of the extinguished liability to be included in assumed proceeds be measured at the carrying amount as of the end of the period for which EPS is being measured. This measurement would lead to dilution when the share price used to compute the end-of-period liability is lower than the average share price used in the treasury stock method. An alternative approach would be to measure the liability used in the assumed proceeds computation at the value at which the liability would have been recorded at the end of the period had the end of the period share price been equal to the average share price during the period. Under that alternative, an instrument subject to the treasury stock method that is classified as a liability and carried at fair value would never be dilutive. Do you agree with the measurement objective in the proposed Statement? Why or why not? If not, would you favor the alternative measurement objective? Why or why not?

## Summary

This proposed Statement would amend FASB Statement No. 128, *Earnings per Share*, to clarify guidance for mandatorily convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or shares.

This proposed Statement would define a mandatorily convertible instrument as one that requires the holder to exchange the instrument for a fixed number of common shares at a specified or determinable future date (or dates) or upon an event that is certain to occur, with little or no consideration upon the exchange other than tendering the instrument. This proposed Statement would require that shares issuable upon conversion of a mandatorily convertible instrument be included in the computation of basic earnings per share (EPS) from the date that future conversion becomes mandatory, regardless of whether the effect of including the additional shares is dilutive or antidilutive.

When applying the treasury stock method for year-to-date diluted EPS, Statement 128 requires that the number of incremental shares included in the denominator be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation. Under this proposed Statement, the number of incremental shares included in year-to-date diluted EPS would be computed using the average market price of common shares for the year-to-date period, independent of the quarterly computations. Similarly, this proposed Statement would require that the number of incremental shares attributable to contingently issuable shares be computed for year-to-date periods independent of the computation used for quarterly EPS computations contained in the year-to-date period.

In addition, this proposed Statement would treat the carrying amount of a liability extinguished upon issuance of shares as assumed proceeds in the computation of incremental shares when applying the treasury stock method to an instrument that is classified as a liability but is potentially settled in shares. This provision would apply only to instruments subject to the treasury stock method and would not affect the EPS computation for instruments that are currently accounted for using the if-converted method.

This proposed Statement also would eliminate the provision of Statement 128 that allows an entity to rebut the presumption that contracts that may be settled in cash or shares will be settled in shares. Consequently, this proposed Statement would require that share settlement be assumed (if dilutive) for any instrument that permits or requires share settlement under any circumstance, unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer of the instrument.

This proposed Statement would be effective for interim and annual periods ending after June 15, 2006. Retrospective application would be required for all changes to Statement 128, except that retrospective application would be prohibited for contracts that were either settled in cash prior to adoption or modified prior to adoption to require cash settlement.

## **Reasons for Issuing This Proposed Statement**

In 1991, the FASB issued a plan (updated in 1995) that proposed steps to increase the range and intensity of its international activities. An objective of that plan was to make financial statements more useful for investors and creditors by increasing the international comparability of accounting standards concurrent with improving the quality of accounting standards. Statement 128 and IAS 33, *Earnings per Share*, were issued as a result of the first technical project undertaken jointly by the FASB and the International Accounting Standards Committee (IASC) (the predecessor of the International Accounting Standards Board [IASB]).

In October 2002, the FASB and the IASB undertook a joint project to achieve more comparability in cross-border financial reporting through convergence to a single set of high-quality accounting standards. Each Board reviewed its pronouncements for areas of its generally accepted accounting principles (GAAP) that could be improved by converging with the other Board's GAAP. Since the issuance of Statement 128 and IAS 33, the IASB reexamined IAS 33 and changed some of its computational guidance. Therefore, EPS computation was identified as an area in which the FASB and the IASB could improve accounting by converging their standards. This proposed Statement would reaffirm the Board's conclusion in Statement 128 that “. . . financial statements could be improved by simplifying the existing computational guidance . . . and increasing the comparability of EPS data on an international basis” (paragraph 75).

## **How the Changes in This Proposed Statement Would Improve Financial Reporting**

By clarifying guidance on mandatorily convertible instruments, the treasury stock method, contracts that may be settled in cash or shares, and contingently issuable shares, this proposed Statement would enhance the comparability of financial statements prepared under U.S. GAAP and those prepared under International Financial Reporting Standards. This result is in accordance with the Board's goal of promoting the international convergence of accounting standards concurrent with improving the quality of financial reporting.

Under Statement 128, the extinguishment of a liability is ignored in the treasury stock method used in computing EPS. Rather, an adjustment is made to the numerator to reverse any mark-to-market income statement effects of the liability for the period. This proposed Statement would modify the definition of assumed proceeds under the treasury stock method to include the carrying amount of any liability that would be extinguished upon exercise. For an instrument that is classified as a liability, carried at fair value, and potentially settled in shares, this provision would result in no incremental shares in many cases because the assumed proceeds from extinguishing the liability would be sufficient to offset any shares assumed issued.

Including the extinguishment of a liability as assumed proceeds in applying the treasury stock method recognizes that the extinguishment of a liability (without sacrificing assets) has the same economic effect on net assets as the receipt of cash proceeds. This change would improve financial reporting by reflecting similar EPS results for economically similar settlement options.

**Proposed Statement of Financial Accounting Standards**

**Earnings per Share**

**an amendment of FASB Statement No. 128**

**September 30, 2005**

**CONTENTS**

	Paragraph Numbers
Introduction.....	1
Standards of Financial Accounting and Reporting:	
Amendments to Statement 128 .....	2
Effective Date and Transition .....	3–4
Appendix A: Background Information and Basis for Conclusions .....	A1–A23
Appendix B: Impact on EITF Issues .....	B1

# Proposed Statement of Financial Accounting Standards

## Earnings per Share

### an amendment of FASB Statement No. 128

September 30, 2005

## INTRODUCTION

1. This Statement clarifies guidance in FASB Statement No. 128, *Earnings per Share*, on mandatorily convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or shares.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Amendments to Statement 128

2. Statement 128 is amended as follows: [Shaded text shows changes proposed in the 2003 Exposure Draft, with added text underscored and deleted text struck out. Unshaded text shows changes proposed during redeliberations, with added text underscored and deleted text struck out.]

a. The provisions relating to basic earnings per share (EPS) are amended as follows:

#### Basic Earnings per Share

8. The objective of basic EPS is to measure the performance of an entity over the reporting period. 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.

9. 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)<sup>3</sup> from income from continuing operations (if that amount appears in the income statement)<sup>4</sup> 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.

10. 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.<sup>5</sup> Shares that will be issued upon conversion of a mandatorily convertible security instrument shall be included in the weighted-average number of shares outstanding used in computing basic EPS from the date that future conversion becomes mandatory (the date the instrument first meets the definition of a mandatorily convertible instrument) using the if-converted method described in paragraph 26 of this Statement, regardless of whether the effect of including the additional shares is dilutive or antidilutive to basic EPS.

---

<sup>3</sup>Preferred dividends that are cumulative only if earned shall be deducted only to the extent that they are earned.

<sup>4</sup>An entity that does not report a discontinued operation but reports an extraordinary item or the cumulative effect of an accounting change in the period shall use that line item (for example, *income before extraordinary items* or *income before accounting change*) whenever the line item *income from continuing operations* is referred to in this Statement.

<sup>5</sup>Thus, contingently issuable shares include shares that (a) will be issued in the future upon the satisfaction of specified conditions, (b) have been placed in escrow and all or part must be returned if specified conditions are not met, or (c) have been issued but the holder must return all or part if specified conditions are not met.

- b. The provisions relating to options, warrants, and their equivalents are amended as follows:

#### **Options and Warrants and Their Equivalents**

17. 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 24 and 50–53 require that another method be applied. Equivalents of options and warrants include nonvested stock granted to employees, stock purchase contracts, and partially paid stock subscriptions.<sup>9</sup> 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.<sup>10</sup>
- 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.<sup>11</sup>

18. 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.

19. Dilutive options or warrants that are issued during a period or that expire or are canceled 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.

#### ***Share-Based Payment Arrangements***

20. Awards of share options and nonvested shares (as defined in FASB Statement No. 123 (revised 2004), *Share-Based Payment*) to be issued to an employee<sup>12</sup> under a share-based compensation arrangement are considered options for purposes of computing diluted EPS. Such share-based awards shall be considered to be outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent upon vesting. Those share-based awards are included in the diluted EPS computation even if the employee 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 compensation 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.

21. In applying the treasury stock method described in paragraph 17, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay upon exercise, (b) the carrying amount as of the end of the period for which EPS is being computed of any liability recognized for the instrument being exercised or share settled that would be extinguished upon exercise or share settlement, (c) the amount of compensation cost attributed to future services and not yet recognized,<sup>13</sup> and ~~(e)~~(d) the amount of excess tax benefits, if any, that would be credited to additional paid-in capital assuming exercise of the options. Assumed proceeds shall not include compensation ascribed to past services, except to the extent that such compensation is recorded as a liability that would be extinguished upon exercise or share settlement. The excess tax benefit is the amount resulting from a tax deduction for compensation in excess of compensation expense recognized for financial reporting purposes. That deduction arises from an increase in the market price of the stock under option between the measurement date and the date at which the compensation deduction for income tax purposes is determinable. The amount of the tax benefit shall be determined by a “with-and-without” computation. Paragraph 63 of Statement 123(R) states that the amount deductible on an employer’s tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in

capital (or its equivalent) pursuant to that paragraph assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds. The provisions of this paragraph apply to all instruments subject to the treasury stock method described in paragraph 17, including but not limited to share-based payment arrangements.

22. If stock-based compensation arrangements are payable in common stock or in cash at the election of either the entity or the employee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 29. ~~If an entity has a tandem [award] (as defined in Statement 123(R)) that allows the entity or the employee 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 expense for that period.~~

23. Awards with a market condition, a performance condition, or any combination thereof (as defined in Statement 123(R)) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 30–35 of this Statement.

<sup>9</sup>Refer to paragraph 64.

<sup>10</sup>Refer to paragraphs 21, 47, and 48.

<sup>11</sup>Consider Corporation Y 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 ( $\$54 \times 10,000$ ) 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.

A shortcut formula for that computation follows (note that this formula may not be appropriate for stock-based compensation awards [refer to paragraph 21]):

Incremental shares =  $[(\text{market price} - \text{exercise price})/\text{market price}] \times \text{shares assumed issued under option}$ ; thus,  $[(\$60 - \$54)/\$60] \times 10,000 = 1,000$  incremental shares.

<sup>12</sup>The provisions in paragraphs 20–23 also apply to share-based awards issued to other than employees in exchange for goods and services.

<sup>13</sup>This provision applies only to those share-based awards for which compensation cost will be recognized in the financial statements in accordance with Statement 123(R).

- c. The provisions relating to contracts that may be settled in stock or cash are amended as follows:

#### **Contracts That May Be Settled in Stock or Cash**

29. 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,<sup>17</sup> ~~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 **presumedassumed** 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 Statement) if the effect is more dilutive. ~~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 26(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.~~ An otherwise cash-settled instrument that contains a provision that requires or permits share settlement upon the occurrence of a specified event or circumstance is not a contingently issuable share agreement; therefore, share settlement of such an instrument must be assumed for purposes of computing diluted EPS if the effect is dilutive. However, if share settlement is permitted or required only in the event of the legal bankruptcy of the issuer, cash settlement shall be assumed unless and until legal bankruptcy occurs.

29A. Paragraph 29 applies to instruments in which the form of settlement (cash or shares) is contingent upon a future event or circumstance (including but not limited to the election of a party to the instrument), but the payoff to the holder of the instrument will be substantially the same regardless of the form in which the instrument is ultimately settled. Paragraph 29 does not apply to instruments for which settlement in cash and settlement in shares do not have substantially the same economic value attached to them. For example, if the economic substance of an instrument is that of convertible debt, it shall be accounted for under paragraph 26 of this Statement, and if the economic substance of an instrument is that of contingently issuable shares, it shall be accounted for under paragraphs 30–34.

---

<sup>17</sup>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. Stock-based compensation arrangements that are payable in common stock or in cash at the election of either the entity or the employee shall be accounted for pursuant to this paragraph.

- d. The provisions relating to contingently issuable shares are amended as follows:

#### **Contingently Issuable Shares**

30. 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).<sup>18</sup>

Paragraphs 31–34 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.

<sup>18</sup> 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.

- e. The provisions relating to applying the treasury stock method to year-to-date computations of EPS are amended as follows:

#### **Year-to-Date Computations**

~~46. 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. Illustration 1 (Full Year 20X1, footnote a) in Appendix C provides an example of that provision. The number of incremental shares included in quarterly and year-to-date diluted EPS shall be computed using the average market price of common shares for the quarterly and year-to-date periods, respectively. For example, an entity with a calendar year-end would compute the number of incremental shares used for its third quarter diluted EPS using the average market price of common shares during the quarter ended September 30, 20X1. The number of incremental shares used to calculate year-to-date diluted EPS at the end of the third quarter would be determined using the average market price of common shares for the year-to-date period ending September 30, 20X1.~~

- f. Illustration 1 is amended as follows:

#### **Illustration 1—Computation of Basic and Diluted Earnings per Share and Income Statement Presentation**

148. This example illustrates the quarterly and annual computations of basic and diluted EPS in the year 20X1 for Corporation A, which has a complex capital structure. The control number used in this illustration (and in Illustration 2) is income before extraordinary item and accounting change because Corporation A has no discontinued operations. Paragraph 149 illustrates the presentation of basic

and diluted EPS on the face of the income statement. The facts assumed are as follows:

*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

The average market price of common stock from July 1 to September 1, 20X1 was \$71.

The average market price of common stock from January 1, 20X1, to September 1, 20X1, was \$66.125.

*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.

*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 the Corporation.

*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.

*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.

*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.

*Tax rate.* The tax rate was 40 percent for 20X1.

<u>Year 20X1</u>	<u>Income (Loss) before Extraordinary Item and Accounting Change<sup>a</sup></u>	<u>Net Income (Loss)</u>
First quarter	\$3,000,000	\$ 3,000,000
Second quarter	4,500,000	4,500,000
Third quarter	500,000	(1,500,000) <sup>b</sup>
Fourth quarter	<u>(500,000)</u>	<u>3,750,000<sup>c</sup></u>
Full year	<u>\$7,500,000</u>	<u>\$ 9,750,000</u>

<sup>a</sup>This is the control number (before adjusting for preferred dividends). Refer to paragraph 15.

<sup>b</sup>Corporation A had a \$2 million extraordinary loss (net of tax) in the third quarter.

<sup>c</sup>Corporation A had a \$4.25 million cumulative effect of an accounting change (net of tax) in the fourth quarter. After the effective date of Statement 154, voluntary changes in accounting principle will no longer be reported via a cumulative-effect adjustment through the income statement of the period of change.

**[Note: For ease of use, the presentation of the quarterly computation of EPS has been omitted from this Statement. EPS for the individual quarters in Illustration 1 is unaffected by this Statement.]**

#### Full Year 20X1

##### Basic EPS Computation

Income before extraordinary item and accounting change	\$ 7,500,000
Less: Preferred stock dividends	<u>(45,000)</u>
<b>Income available to common stockholders</b>	7,455,000
Extraordinary item	(2,000,000)
Accounting change	<u>4,250,000</u>
Net income available to common stockholders	<u>\$ 9,705,000</u>

<u>Dates</u> <u>Outstanding</u>	<u>Shares</u> <u>Outstanding</u>	<u>Fraction</u> <u>of Period</u>	<u>Weighted-</u> <u>Average Shares</u>
January 1–February 28	3,300,000	2/12	550,000
<i>Issuance of common stock on March 1</i>	<u>100,000</u>		
March 1–March 31	3,400,000	1/12	283,333
<i>Conversion of 4% debenture on April 1</i>	<u>200,000</u>		
April 1–May 31	3,600,000	2/12	600,000
<i>Conversion of preferred stock on June 1</i>	<u>500,000</u>		
June 1–August 31	4,100,000	3/12	1,025,000
<i>Exercise of warrants on September 1</i>	<u>500,000</u>		
September 1–December 31	4,600,000	4/12	<u>1,533,333</u>
<b>Weighted-average shares</b>			<u><u>3,991,666</u></u>

### Basic EPS

Income before extraordinary item and accounting change	<b>\$ 1.87</b>
Extraordinary item	<b>\$(0.50)</b>
Accounting change	<b>\$ 1.06</b>
Net income	<b>\$ 2.43</b>

The equation for computing basic EPS is:

$$\frac{\text{Income available to common stockholders}}{\text{Weighted-average shares}}$$

## Full Year 20X1

### Diluted EPS Computation

<b>Income available to common stockholders</b>		\$ 7,455,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	\$ 45,000	
Interest on 4% convertible debentures	<u>60,000</u>	
<b>Effect of assumed conversions</b>		<u>105,000</u>
Income available to common stockholders + assumed conversions		7,560,000
Extraordinary item		(2,000,000)
Accounting change		<u>4,250,000</u>
Net income available to common stockholders + assumed conversions		<u>\$ 9,810,000</u>
 <b>Weighted-average shares</b>		 3,991,666
Plus: Incremental shares from assumed conversions		
Warrants	<u>30,876</u>	<del>30,768</del> <sup>a</sup>
Convertible preferred stock	308,333 <sup>b</sup>	
4% convertible debentures	<u>50,000</u> <sup>c</sup>	
<b>Dilutive potential common shares</b>		<u>389,101</u> <u>389,209</u>
Adjusted weighted-average shares		<u>4,380,767</u> <u>4,380,875</u>

### Diluted EPS

Income before extraordinary item and accounting change		<b>\$ 1.73</b>
Extraordinary item		<b>\$(0.46)</b>
Accounting change		<b>\$ 0.97</b>
Net income		<b>\$ 2.24</b>

The equation for computing diluted EPS is:

$$\frac{\text{Income available to common stockholders} + \text{Effect of assumed conversions}}{\text{Weighted-average shares} + \text{Dilutive potential common shares}}$$

<sup>a</sup>~~(71,429 shares × 3/12) + (51,643 shares × 3/12)[(66.125 - 60) / 66.125] × 500,000 = 46,314 × 8/12 =~~  
30,876 shares

<sup>b</sup>(600,000 shares × 5/12) + (100,000 shares × 7/12)

<sup>c</sup>200,000 shares × 3/12

g. Illustration 2 is amended as follows:

**Illustration 2—Earnings per Share Disclosures**

151. The following is an illustration of the reconciliation of the numerators and denominators of the basic and diluted EPS computations for “income before extraordinary item and accounting change” and other related disclosures required by paragraph 40 for Corporation A in Illustration 1. ~~Note: Statement 123(R) has specific disclosure requirements related to [share]-based compensation arrangements.~~

	<b>For the Year Ended 20X1</b>		
	<b>Income (Numerator)</b>	<b>Shares (Denominator)</b>	<b>Per-Share Amount</b>
Income before extraordinary item and accounting change	\$7,500,000		
Less: Preferred stock dividends	<u>(45,000)</u>		
<b>Basic EPS</b>			
Income available to common stockholders	7,455,000	3,991,666	<u>\$1.87</u>
<b>Effect of Dilutive Securities</b>			
Warrants		<del>30,768</del> <u>30,876</u>	
Convertible preferred stock	45,000	308,333	
4% convertible debentures	<u>60,000</u>	<u>50,000</u>	
<b>Diluted EPS</b>			
Income available to common stockholders + assumed conversions	<u>\$7,560,000</u>	<del>4,380,767</del> <u>4,380,875</u>	<u>\$1.73</u>

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.

h. Illustration 3 is amended as follows:

**Illustration 3—Contingently Issuable Shares**

152. The following example illustrates the contingent share provisions described in paragraphs 10 and 30–35. The facts assumed are as follows:

- Corporation B 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.
- Terms of a contingent stock agreement related to a recent business combination provided the following to certain shareholders of the Corporation:
  - 1,000 additional common shares for each new retail site opened during 20X1
  - 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.
- The Corporation opened two new retail sites during the year:
  - One on May 1, 20X1
  - One on September 1, 20X1.
- Corporation B's consolidated, year-to-date after-tax net income was:
  - \$400,000 as of March 31, 20X1
  - \$600,000 as of June 30, 20X1
  - \$450,000 as of September 30, 20X1
  - \$700,000 as of December 31, 20X1.

**Note:** In computing diluted EPS for an interim, year-to-date, or annual period, contingent shares are included as of the beginning of the period in which the contingency is met (or would have been met if the end of the reporting period was the end of the contingency period), or the date of the contingent share agreement, if later. ~~For year-to-date computations, footnote 18 of this Statement requires that contingent shares be included on a weighted-average basis.~~

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>Full Year</u>
<b>Basic EPS Computation</b>					
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 <sup>a</sup>	1,333 <sup>b</sup>	2,000	1,000 <sup>c</sup>
Earnings contingency <sup>d</sup>	0	0	0	0	0
Total shares	<u>100,000</u>	<u>100,667</u>	<u>101,333</u>	<u>102,000</u>	<u>101,000</u>
Basic EPS	<u>\$ 4.00</u>	<u>\$ 1.99</u>	<u>\$ (1.48)</u>	<u>\$ 2.45</u>	<u>\$ 6.93</u>

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>Full Year</u>
<b>Diluted EPS Computation</b>					
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	<u>2,000</u> 1,250 <sup>e</sup>
Earnings contingency	0 <sup>f</sup>	5,000 <sup>g</sup>	0 <sup>h</sup>	10,000 <sup>i</sup>	<u>10,000</u> 3,750 <sup>j</sup>
Total shares	<u>100,000</u>	<u>106,000</u>	<u>102,000</u>	<u>112,000</u>	<u>112,000</u> 105,000
Diluted EPS	<u>\$ 4.00</u>	<u>\$ 1.89</u>	<u>\$ (1.47)<sup>k</sup></u>	<u>\$ 2.23</u>	<u>\$6.25</u> \$6.67

<sup>a</sup> 1,000 shares × 2/3

<sup>b</sup> 1,000 shares + (1,000 shares × 1/3)

<sup>c</sup> (1,000 shares × 8/12) + (1,000 shares × 4/12)

<sup>d</sup> 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 (paragraphs 10 and 31). 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.

<sup>e</sup>  $(0 + 1,000 + 2,000 + 2,000) \div 4$  1,000 shares + 1,000 shares

<sup>f</sup> Corporation B 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 Statement.

<sup>g</sup>  $[(\$600,000 - \$500,000) \div \$100] \times 5$  shares

<sup>h</sup> Year-to-date, after-tax net income was less than \$500,000.

<sup>i</sup>  $[(\$700,000 - \$500,000) \div \$100] \times 5$  shares

<sup>j</sup>  $(0 + 5,000 + 0 + 10,000) \div 4$   $[(\$700,000 - \$500,000) \div \$100] \times 5$  shares

<sup>k</sup> Loss during the third quarter is due to a change in accounting principle; therefore, antidilution rules (paragraph 15) do not apply.

- i. Paragraph 171 (the glossary) is amended as follows:

**Mandatorily convertible instrument**

An instrument that requires the holder to exchange the instrument for a fixed number of common shares at a specified or determinable future date (or dates) or upon an event that is certain to occur, with little or no consideration upon the exchange other than tendering the instrument. An instrument that meets that definition but contains a provision providing for adjustment of the fixed number of shares upon occurrence of an equity restructuring event such as a stock dividend or split is still a mandatorily convertible instrument. An instrument that will convert into a variable number of shares is not a mandatorily convertible instrument because a contingency remains (the number of shares is not known), except to the extent that there is a minimum number of shares that will be issued. In that case, the minimum shares that will be issued are considered mandatorily convertible, and any additional shares that may be issued are not.

- j. Paragraph 172 (Other Literature on Earnings per Share) is amended as follows:

- (1) The section under *Effect of Statement 128* on EITF Issue No. 85-18—“Earnings-per-Share Effect of Equity Commitment Notes” is amended as follows:

Statement 128 contradicts the consensus reached. Statement 128 states that contracts that may be settled in stock or cash should be ~~presumed~~assumed to be settled in stock and reflected in the computation of diluted EPS ~~unless past experience or a stated policy provides a reasonable basis to believe otherwise~~(if dilutive), unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer of the instrument. [29]

Statement 128 supports the consensus reached; equity contracts that require payment in stock should be considered potentially dilutive securities (convertible debt). [26–28]

- (2) The section under *Effect of Statement 128* on EITF Issue No. 90-19—“Convertible Bonds with Issuer Option to Settle for Cash upon Conversion” is amended as follows:

Statement 128 implicitly supports the consensus reached; this type of security does not meet the definition of potential common stock. [171]

Statement 128 implicitly supports the consensus reached. Contracts that may be settled in stock or cash should be ~~presumed~~assumed to be settled in stock and reflected in the computation of diluted EPS ~~unless past experience or a stated policy provides a reasonable basis to believe otherwise~~(if dilutive), unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer of the instrument. [29]

Statement 128 implicitly supports the consensus reached for diluted EPS. [29]

- (3) The section under *Effect of Statement 128* on EITF Issue No. 94-7—“Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock” is amended as follows:

Statement 128 states that contracts that may be settled in stock or cash should be ~~presumed~~assumed to be settled in stock and reflected in the computation of diluted EPS ~~unless past experience or a stated policy provides a reasonable basis to believe otherwise~~(if dilutive), unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer of the instrument. [29]

In computing diluted EPS, Statement 128 requires use of the reverse treasury stock method to account for the dilutive effect of written put options and similar contracts that are “in the money” during the reporting period. Statement 128 states that purchased options should not be reflected in the computation of diluted EPS because to do so would be antidilutive. [24, 25]

#### **Effective Date and Transition**

3. This Statement shall be effective for financial statements for periods ending after June 15, 2006. After the effective date, all prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of this Statement, except as indicated in the next paragraph.

4. Retrospective application is prohibited for contracts that, on or before the last day of the period of adoption, have been settled for cash or modified such that the issuer no longer has the option to settle in shares.

**The provisions of this Statement need  
not be applied to immaterial items.**

## Appendix A

### BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

#### Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others. This appendix summarizes the basis for the Board's conclusions during redeliberations of the 2003 Exposure Draft. The basis for the Board's conclusions contained in the 2003 Exposure Draft is not repeated in this appendix except when necessary to provide context.

A2. In September 2002, the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) made a commitment to converge the accounting standards of their respective jurisdictions through a long-term convergence plan. As part of that plan, the Boards jointly undertook a short-term project to eliminate certain differences between the accounting pronouncements of the IASB and the accounting pronouncements in effect in the United States. Both Boards agreed to limit the scope of the short-term project to issues for which (a) the Boards' respective accounting pronouncements were divergent; (b) convergence to a high-quality solution appears achievable in the short-term, usually by selecting between the existing standards of either the FASB or the IASB; and (c) the issue was not within the scope of other projects on the current agendas of either Board. The Boards hope that the short-term convergence project will simplify cross-border financial reporting by reducing the number of items required to reconcile reports prepared under U.S. generally accepted accounting principles (GAAP) to those prepared under International Financial Reporting Standards (IFRS).

#### Earnings per Share

A3. In 1991, the FASB issued a plan (which was updated in 1995) that proposed steps to increase the range and intensity of its international activities. An objective of that plan was to make financial statements more useful for investors and creditors by increasing the international comparability of accounting standards concurrent with improving the quality of accounting standards. FASB Statement No. 128, *Earnings per Share*, and IAS 33, *Earnings per Share*, were issued as a result of the first joint technical project undertaken by the FASB and the International Accounting Standards Committee (IASC) (the predecessor of the IASB).

A4. Since the issuance of Statement 128 and IAS 33, the IASB has reexamined IAS 33 and made changes to enhance the computational guidance for EPS. The Boards identified EPS computation as an issue suitable for the joint short-term convergence project in part because EPS is widely used as an indicator of corporate performance. By converging with IASB guidance, the Board reaffirms its conclusion in Statement 128 that “. . . financial statements could be improved by simplifying the existing computational guidance . . . and increasing the comparability of EPS data on an international basis” (paragraph 75).

A5. As a result of the short-term convergence project, the Board issued an Exposure Draft, *Earnings per Share*, in December 2003 for a 120-day comment period. The Board received 29 comment letters on the 2003 Exposure Draft, and in 2004 and 2005, the Board redeliberated the issues identified. Most of the conclusions and considerations from the 2003 Exposure Draft were affirmed in redeliberations. However, the Board concluded that certain additional decisions made during redeliberations warrant reexposure. Therefore, this appendix addresses decisions made during redeliberations that differ from the provisions of the 2003 Exposure Draft.

### **Mandatorily Convertible Instruments**

A6. The 2003 Exposure Draft proposed that shares issuable upon conversion of a mandatorily convertible security be included in the weighted-average number of shares outstanding used in computing basic EPS from the date that future conversion becomes mandatory, using the if-converted method. Several respondents pointed out that there are many financial instruments and packages of financial instruments that financial market participants broadly refer to as “mandatorily convertible securities.” Because the 2003 Exposure Draft did not include a definition, some respondents questioned whether a particular security would be considered mandatorily convertible. Therefore, the Board decided to define a mandatorily convertible instrument.

A7. IAS 33 does not contain a definition of or explanatory language on the meaning of *mandatorily convertible instrument*; however, the Board decided to include the definition in this Statement to provide more guidance on what is meant by a mandatorily convertible instrument.

A8. The Board decided against providing guidance on every type of instrument that could be considered mandatorily convertible because the Board believes that determining whether an instrument is mandatorily convertible may require judgment in practice.

A9. A number of respondents recommended that the Statement clarify whether the Board intended to require that the effect of a mandatorily convertible instrument be included in the calculation of basic EPS, even when the effect is antidilutive. The Board believes that mandatorily convertible instruments are similar to contingently issuable shares in many respects. Paragraph 10 of Statement 128 requires that contingently issuable shares be included in the computation of basic EPS as of the date that all necessary conditions have been satisfied. The Board reasoned that because the conversion into shares of mandatorily convertible instruments is contingent only on the passage of time, those instruments should be included in the computation of basic EPS, whether the effect of including the additional shares is dilutive or antidilutive. The Board noted that the distinction between dilutive and antidilutive effects is not pertinent to this decision, which concerns basic EPS computation.

### **Instruments That May Be Settled in Cash or Shares**

A10. Statement 128 requires that for purposes of computing diluted EPS, an entity must assume that a contract that could be settled in cash or shares would be settled in shares if

share settlement is more dilutive, unless past experience or a stated policy provides a reasonable basis to believe that the contract would be paid partially or wholly in cash. Under the IASB approach, the presumption that such contracts will be settled in common shares if that settlement would be more dilutive may not be rebutted. The Board decided that the IASB's provisions would result in more consistent EPS calculations. Therefore, it decided to converge with the IASB's provision that that presumption (contracts that could be settled in either cash or shares would be settled in shares) cannot be overcome. That decision was presented in the 2003 Exposure Draft.

A11. Many respondents questioned whether the phrase *at the election of the entity or the holder* in paragraph 29 of Statement 128 means that circumstances that are outside the election of the entity or the holder, which permit or require share settlement, fall outside the scope of paragraph 29. The Board believes that the objective of computing diluted EPS, as stated in paragraph 79 of Statement 128, requires that all potentially dilutive shares be reflected in the computation of diluted EPS. As a result, the Board decided that an otherwise cash-settled instrument that contains a provision that requires or permits share settlement under certain circumstances is not a contingently issuable share agreement and, therefore, share settlement must be assumed (if dilutive) for purposes of computing diluted EPS, regardless of control over or probability of share settlement. However, the Board decided to make an exception to this guidance for instruments that do not permit share settlement under any circumstance other than the legal bankruptcy of the issuer because of the common practice of including bankruptcy provisions in these agreements. The Board also considered making an exception for instruments that permit share settlement in the event of default. However, the Board decided against that exception because that exception might encourage issuers to create contracts that include circumstances that permit or require share settlement to circumvent the intent of diluted EPS.

A12. When an entity has a stated policy or a past practice of settling an obligation in cash, EPS computations have historically excluded the possibility of share settlement. As a result of the Board's decision to remove the ability to overcome the share settlement presumption in paragraph 29, certain instruments classified as liabilities for financial reporting purposes are now assumed to be settled in shares for EPS purposes (if dilutive).

A13. Proceeds from exercise of options or warrants are assumed to be used to purchase common shares at the average market price during the period. If an instrument classified as a liability were actually settled in shares, the liability for that instrument would be extinguished without sacrifice of assets, and the amount of the liability would be credited to paid-in capital. The extinguishment of that liability would represent an increase in the issuer's net assets identical to that of cash proceeds from issuing shares in exchange for cash. Therefore, the Board decided that when applying the treasury stock method to an instrument classified as a liability but potentially settled in shares, the carrying amount of an extinguished liability upon issuance of the shares should be included as assumed proceeds in the computation of incremental shares. The Board noted that for an instrument that is classified as a liability, carried at fair value, and potentially settled in shares, this provision would result in no incremental shares under the treasury stock method in many cases because the assumed proceeds from extinguishing the liability would be sufficient to

offset any shares assumed issued. The Board decided that that result is appropriate because changes in the value of that liability are fully reflected in the numerator of the EPS computation and no adjustment of the denominator should be necessary. The Board reasoned that issuance of a share in exchange for extinguishment of a liability equal to the value of that share is not dilutive to existing shareholder interests, just as a share issued for cash proceeds equal to its value is not dilutive under the treasury stock method. That decision does not affect the EPS computation for instruments that are currently accounted for using the if-converted method under Statement 128.

A14. The Board noted that its decision to include liability extinguishment as an element of assumed proceeds under the treasury stock method could have been extended to the provisions of Statement 128 applicable to convertible debt instruments. Application of the if-converted method ignores the extinguishment of a liability in the form of a convertible debt instrument; therefore, a convertible debt instrument can be dilutive even if the face value of the debt exceeds the value of the shares into which the instrument is convertible. The Board considered modifying the computation of the dilutive effect of convertible securities but decided that to do so would be outside the scope of the short-term convergence project. The Board acknowledges that its decision on how to apply the treasury stock method does not resolve practice issues about whether some instruments should be considered convertible debt instruments, contingent share arrangements, or instruments subject to the treasury stock method. The Board believes that those questions will be easier to answer after resolving certain issues of balance sheet classification that are under study in the Board's project on liabilities and equity. Thus, the Board decided to defer further changes to the computation of EPS and consider them in that project.

### **Contingently Issuable Shares**

A15. Statement 128 requires that contingently issuable shares be determined for year-to-date periods on a weighted-average basis. That treatment is inconsistent with paragraph 2(c) of the 2003 Exposure Draft, which would eliminate the weighted-average computation in applying the treasury stock method. In addition, that treatment is inconsistent with IAS 33, which requires that contingently issuable shares be included in diluted EPS from the beginning of the period that the conditions for issuance are satisfied, or the date of the contingent share arrangement, if later. Therefore, the Board decided to amend the requirements for computing contingently issuable shares to be consistent with the amended requirements for the treasury stock method and with IAS 33. Contingently issuable shares should be included in diluted EPS from the beginning of the period during which the contingency has been satisfied, or from the date of the contingent share agreement, if later.

### **Convergence of U.S. GAAP and International Financial Reporting Standards**

A16. This Statement is the result of a broader effort by the FASB to improve the comparability of cross-border financial reporting by working with the IASB toward development of a single set of high-quality accounting standards. Although convergence is an important objective in this Statement, the guidance in this Statement and the guidance in IAS 33 differ in their respective descriptions of assumed proceeds under the

treasury stock method of computing EPS. In other areas, the guidance in this Statement goes beyond the level of detail provided in IAS 33.

A17. This Statement amends the description of assumed proceeds in Statement 128 to include the carrying amount of any liability that would be extinguished upon exercise of an instrument subject to the treasury stock method. IAS 33 does not specifically include the carrying amount of an extinguished liability as part of assumed proceeds. As a result of this difference, the computation of incremental shares attributable to a liability that is potentially share settled could be different under U.S. GAAP and IFRS.

A18. This Statement provides application guidance for mandatorily convertible instruments. In particular, this Statement defines a mandatorily convertible instrument and specifies that shares that would be issued as a result of mandatory conversion should be assumed issued, regardless of whether they would be dilutive or antidilutive. In addition, this Statement clarifies the interaction between the guidance in paragraph 29 of Statement 128 on instruments that may be settled in cash or shares and the guidance in paragraph 30 of Statement 128 on contingently issuable shares. This Statement specifies that an otherwise cash-settled instrument that contains a provision that requires or permits share settlement upon the occurrence of a specified event or circumstance is not a contingently issuable share agreement. While IAS 33 does not contain guidance that specifically conflicts with the application guidance in this Statement, it does not explicitly provide similar guidance.

A19. In keeping with its stated goal of international convergence, the IASB intends to consider any remaining differences between U.S. GAAP and IFRS related to EPS when this Statement is issued in final form.

### **Effective Date and Transition**

A20. The Board decided that this Statement should be effective for fiscal periods ending after June 15, 2006. The Board does not anticipate significant changes in financial reporting to result from applying the provisions of this Statement and, therefore, does not believe that significant lead time is required prior to implementation. In addition, the Board believes that affected entities will have had ample time to anticipate the changes required by this Statement during the period between deliberations and issuance of a final Statement.

A21. The 2003 Exposure Draft reflected the Board's decision that retrospective application would be appropriate because the cost would not be excessive in relation to the benefits to users of financial statements. Some respondents stated that they intended to amend certain existing contracts to remove share settlement provisions so that the contracts would not have a dilutive effect on EPS. Those respondents pointed out that applying this Statement retrospectively to those contracts would result in dilution in prior years even though the contracts were not and never would be settled in shares. Those respondents asked the Board to consider an exception to the retrospective application of this Statement for those contracts that were settled in cash prior to the effective date of this Statement and for those contracts that were amended to eliminate the share settlement

option prior to the effective date of this Statement. The Board decided that this exception to the transition requirements of this Statement is a reasonable accommodation to preparers and will not compromise the quality of financial information provided to users.

### **Benefits and Costs**

A22. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

A23. The Board does not expect that the cost of implementing the provision of this Statement will be significant, and it notes that converging with the IASB's EPS computation will reduce costs for entities that prepare cross-border financial statements. In addition to reducing costs associated with preparing cross-border financial statement reconciliations, this Statement brings the FASB and the IASB closer to a common approach to computing EPS.

## Appendix B

### IMPACT ON EITF ISSUES

B1. This appendix addresses the impact of this Statement on the consensuses reached on EITF Issues relating to EPS. This appendix does not address the impact of this Statement on other authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy discussed in AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

<b>Issue Number</b>	<b>Title</b>	<b>Status</b>	<b>Analysis</b>
85-18	Earnings-per-Share Effect of Equity Commitment Notes	Status Amended	The status section of Issue 85-18 notes that Statement 128 nullifies the first consensus in Issue 85-18 by stating that contracts that may be settled in stock or cash should be presumed to be settled in stock and reflected in the computation of diluted EPS unless past experience or a stated policy provides a reasonable basis to believe otherwise. This Statement eliminates the ability to rebut that presumption because past experience or a stated policy provides a reasonable basis to believe otherwise.
90-19	Convertible Bonds with Issuer Option to Settle for Cash upon Conversion	Status Amended	Issue 3 of Issue 90-19 states that for Instrument C, described therein, the conversion spread should be included in diluted EPS based on the provisions of paragraph 29 of Statement 128 and EITF Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share." This Statement eliminates the ability to overcome the presumption in paragraph 29 of Statement 128 that a contract that may be settled in stock or cash will be settled in common stock and the resulting potential shares included in diluted EPS if the effect is more dilutive. Therefore, share settlement of the conversion spread must be assumed, unless the only circumstance that would permit or require share settlement is the bankruptcy of the issuer.

<b>Issue Number</b>	<b>Title</b>	<b>Status</b>	<b>Analysis</b>
97-14	Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested	Partially Nullified	The Task Force reached a consensus that employer shares held by the 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 arrangements should be reflected in the denominator of the EPS computation in accordance with the provisions of Statement 128. Thus, if the obligation may be settled by delivery of cash, shares of employer stock, or diversified assets (other than Plan A), those shares would not be reflected in basic EPS but would be included in the calculation of diluted EPS in accordance with paragraphs 22 and 29 of Statement 128. This Statement eliminates the ability to overcome the presumption in paragraph 29 of Statement 128 that a contract that may be settled in stock or cash will be settled in common stock and the resulting potential shares included in diluted EPS if the effect is more dilutive.
98-12	Application of Issue No. 00-19 to Forward Equity Sales Transactions	Partially Nullified	The Task Force reached a consensus that for the purpose of computing EPS, the effect of the forward equity sales transaction on the diluted EPS calculation would be determined using the guidance provided in Statement 128 and the guidance in Topic D-72. This Statement eliminates the ability to overcome the presumption in paragraph 29 of Statement 128 that a contract that may be settled in stock or cash will be settled in common stock and the resulting potential shares included in diluted EPS if the effect is more dilutive. Thus, the EPS calculation assumption (b) in footnote 1 is nullified.
99-7	Accounting for an Accelerated Share Repurchase Program	Partially Nullified	The Task Force reached a consensus that for the purpose of computing EPS, the effect of the forward equity sales transaction on the diluted EPS calculation would be determined using the guidance provided in Statement 128 and the guidance in Topic D-72. This Statement eliminates the ability to overcome the presumption in paragraph 29 of Statement 128 that a contract that may be settled in stock or cash will be settled in common stock and the resulting potential shares included in diluted EPS if the effect is more dilutive.

<b>Issue Number</b>	<b>Title</b>	<b>Status</b>	<b>Analysis</b>
00-19	Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock	Partially Nullified	<p>Paragraph 49 states, in accordance with an FASB staff representative announcement (Topic D-72), that for those contracts that provide the company with a choice of settlement methods, the company should assume that the contract will be settled in shares. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that it is probable that the contract will be paid partially or wholly in cash. This Statement eliminates the ability to overcome that presumption.</p> <p>Paragraph 49 then states that in accordance with that same FASB staff announcement, 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 should be used. This Statement reaffirms that position.</p>
03-6	Participating Securities and the Two-Class Method under FASB Statement No. 128	Partially Nullified	<p>The Task Force reached a consensus that convertible participating securities should be included in the computation of basic EPS using the two-class method. This Statement requires that mandatorily convertible securities be included in the computation of basic EPS using the if-converted method, regardless of whether the effect is dilutive or antidilutive. Therefore, this Statement nullifies the consensus reached in Issue 03-6 for mandatorily convertible securities with participation features.</p>
D-62	Computing Year-to-Date Diluted Earnings per Share under FASB Statement No. 128	Nullified	<p>Topic D-62 addresses the computation of year-to-date diluted earnings per share in accordance with the weighted-average provisions of paragraph 46 of Statement 128. This Statement amends paragraph 46 to require that year-to-date diluted earnings per share be computed without regard to quarterly computations. Thus, Topic D-62 is nullified.</p>
D-72	Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share	Nullified	<p>Topic D-72 addresses the earnings per share treatment of instruments that may be settled in cash or shares, including whether a numerator adjustment is required. This Statement amends Statement 128, eliminating the numerator adjustment for those instruments. Thus, Topic D-72 is nullified.</p>