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# 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 September 30, 2005**

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. 1240-100

Comment Deadline: December 5, 2008

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 December 5, 2008. Interested parties should submit their comments by email to director@fasb.org, File Reference 1240-100. Those without email may send their comments to the "Technical Director—File Reference 1240-100" 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.

An electronic copy of this Exposure Draft is available on the FASB's website until the FASB issues a final document. Any individual or organization may obtain one copy of this Exposure Draft without charge until December 5, 2008, on written request only. **Please ask for our Product Code No. E197.** For information on applicable prices for additional copies and copies requested after December 5, 2008, contact:

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## Notice for Recipients of This Exposure Draft

The FASB is issuing this proposed Statement as part of a joint project with the International Accounting Standards Board (IASB). The FASB and the IASB undertook that project to eliminate differences between FASB Statement No. 128, *Earnings per Share,* and IAS 33, *Earnings per Share,* in ways that also would clarify and simplify the earnings per share (EPS) computation. This proposed Statement proposes amendments to Statement 128. The IASB also issued an Exposure Draft proposing amendments to IAS 33. Those proposed amendments, taken together, would improve the comparability of EPS because the denominator used to compute EPS under Statement 128 would be the same as the denominator used to compute EPS under IAS 33, with limited exceptions. Those limited exceptions relate to certain instruments for which the underlying accounting under U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) is different.

## Information for Respondents

This proposed Statement is a revision of the FASB Exposure Draft, *Earnings per Share,* which was issued in September 2005. Given the length of time that has lapsed since the issuance of the 2005 Exposure Draft, this proposed Statement includes amendments of Statement 128 (and related literature) relating to all of the decisions reached in this project. However, the Board is particularly interested in comments by individuals and organizations on the following major changes from the 2005 Exposure Draft:

1. The inclusion of the following instruments in basic EPS:
    a. An instrument that is currently exercisable for little or no cost to the holder
    b. Shares that are currently issuable for little or no cost to the holder
    c. A mandatorily convertible instrument that is a participating security
2. The guidance on instruments that are measured at fair value each period with changes in fair value recognized in earnings
3. The inclusion of the end-of-period carrying value of a liability that is not remeasured at fair value each period as assumed proceeds and the use of the end-of-period market price rather than the average market price for the period when determining the denominator of diluted EPS under the treasury stock and reverse treasury stock methods
4. The computational guidance on computing diluted EPS under the two-class method.

Comments are requested from those who agree with the provisions of this proposed Statement and from those who do not.

Comments are most helpful if they identify the issues or the specific paragraph or paragraphs to which the comments relate and clearly explain the problem or question.

Those who disagree with provisions of this proposed Statement are asked to describe their suggested alternatives, supported by specific reasoning.

The Board specifically requests comments on the following.

## Instruments That Are Measured at Fair Value Each Period with Changes in Fair Value Recognized in Earnings

*Issue 1:* In this proposed Statement, an entity would not include in the denominator of diluted EPS the number of additional common shares that would arise from the assumed exercise or conversion of certain freestanding instruments (or a component of certain compound instruments that is accounted for as if it were freestanding) that are measured at fair value each period with changes in fair value recognized in earnings. Similarly, an entity would not include in the computation of basic and diluted EPS under the two-class method certain participating securities that are measured at fair value each period with changes in fair value recognized in earnings. The Board concluded that the effect of those instruments on current shareholders during the period has been reflected in the numerator of basic and diluted EPS through the changes in fair value recognized in earnings. Do you agree that the fair value changes sufficiently reflect the effect of those instruments on current shareholders and that recognizing those changes in earnings eliminates the need to include those instruments in determining the denominator of diluted EPS or in computing EPS under the two-class method? If not, why not?

## Diluted EPS under the Two-Class Method

*Issue 2:* In computing diluted EPS, dilutive potential common shares and potential participating securities are assumed to be outstanding. This proposed Statement would clarify that an entity would not reduce income from continuing operations (or net income) by the amount of additional dividends that would be assumed to be declared for potential common shares or potential participating securities that are assumed to be outstanding. The Board reasoned that an entity may make a different decision on the per-share amount of dividends declared if that per-share amount was distributed to all potential common shares or participating securities. Do you agree? If not, why not?

### Disclosures

*Issue 3:* The Board decided that the amendments in this proposed Statement would not warrant additional disclosures beyond those already required by U.S. GAAP (for example, Statement 128, FASB Statement No. 129, *Disclosure of Information about Capital Structure,* and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"). Do you agree that additional disclosures are not warranted? If not, what additional disclosures should be required and why?

# Summary

## Why Is the FASB Issuing This Proposed Statement and When Will It Be Effective?

The objective of this proposed Statement is to amend FASB Statement No. 128, *Earnings per Share,* so as to clarify and simplify the computation of earnings per share (EPS) and converge the requirements of Statement 128 with those of IAS 33, *Earnings per Share*. The International Accounting Standards Board (IASB) also has issued a proposed Statement of amendments to IAS 33. Those proposed amendments, taken together, would improve the comparability of EPS because the denominator used to compute EPS under Statement 128 would be the same as the denominator used to compute EPS under IAS 33, with limited exceptions. Those limited exceptions relate to certain instruments for which the underlying accounting under U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) is different.

An entity would be required to apply the requirements of this proposed Statement as of the beginning of a fiscal year, and interim periods within those fiscal years, generally through retrospective application to prior periods. Earlier application would be prohibited. The Board will set the effective date for the amendments when it approves the final amendments to Statement 128.

## How Will This Proposed Statement Change Current Practice?

This proposed Statement would clarify that the computation of basic EPS should include outstanding common shares and instruments that the holder has (or is deemed to have) the right to share in current-period earnings with common shareholders.

This proposed Statement would clarify that because the effect of certain freestanding instruments (or a component of certain compound instruments that is accounted for as if it were freestanding) that are measured at fair value each period with changes in fair value recognized in earnings is reflected in the numerator of diluted EPS, the denominator of diluted EPS should not be increased for the additional common shares that would arise from the exercise or conversion of the instrument. Similarly, an entity would not include in the computation of basic and diluted EPS under the two-class method certain participating securities that are measured at fair value each period with changes in fair value recognized in earnings.

This proposed Statement would modify the treasury stock and reverse treasury stock methods in three ways. First, it would require an entity to include the end-of-period carrying value of certain liabilities as assumed proceeds. Second, it would simplify the EPS computation by requiring an entity to use the end-of-period market price of common shares in computing the number of incremental shares that would be issued upon an assumed exercise or conversion. Third, the EPS computation also would be simplified by requiring an entity to compute EPS each period independently from any prior-period computation.

This proposed Statement would require an entity to assume share settlement when computing diluted EPS for an instrument that permits or requires either cash settlement or share settlement, unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer.

This proposed Statement also would clarify the requirements of Statement 128 for allocating undistributed earnings when using the two-class method to compute diluted EPS. In particular, an entity would adjust the numerator for the undistributed earnings associated with potential common shares or potential participating securities that are assumed to be outstanding for diluted EPS purposes, but it would not adjust the numerator by additional dividends that would be assumed to be declared for the potential common shares or potential participating securities that are assumed to be outstanding.

## How Will This Proposed Statement Improve Financial Reporting?

This proposed Statement, together with the proposed amendments to IAS 33, would enhance the comparability of EPS by reducing the differences between the EPS denominator reported under U.S. GAAP and IFRS as well as by simplifying the application of Statement 128. This result would be in accordance with the Board's goal of promoting the international convergence of accounting standards concurrent with improving the quality of financial reporting.

## What Is the Effect of This Proposed Statement on Convergence with International Financial Reporting Standards?

The IASB has issued a proposed Statement to amend IAS 33. Together, the proposed changes to Statement 128 and IAS 33 would result in the same EPS denominator reported under U.S. GAAP and IFRS, with limited exceptions. The Boards believe that developing a common set of high-quality financial accounting standards would improve the comparability of financial information around the world and would simplify the accounting for entities that issue financial statements in accordance with U.S. GAAP or IFRS.

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

**August 7, 2008**

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**Proposed Statement of Financial Accounting Standards**

**Earnings per Share**

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

**August 7, 2008**

## OBJECTIVE

1. This Statement amends FASB Statement No. 128, *Earnings per Share*, to clarify and simplify the computation of earnings per share (EPS). The EPS denominator used to compute EPS under Statement 128 would be the same as the EPS denominator used to compute EPS under IAS 33, *Earnings per Share*, as proposed to be amended, with limited exceptions. Those limited exceptions relate to certain instruments for which the underlying accounting under U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) is different. Accordingly, the comparability of EPS on an international basis would be improved.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

## Basic Earnings per Share

2. An entity shall include in the computation of basic EPS all common shares outstanding and instruments for which the holder has (or is deemed to have) the present right as of the end of the period to share in current-period earnings with common shareholders. Examples of those instruments include the following:

a. An instrument that is currently exercisable for little or no cost to the holder
b. Shares that are currently issuable for little or no cost to the holder
c. A participating security that is not measured at fair value each period with changes in fair value recognized in current-period earnings
d. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

3. For purposes of applying the little-or-no-cost criterion in paragraphs 2(a) and 2(b), *cost* refers to the amount required to be paid by the holder, whether in the form of cash, other assets, or services rendered (such as employee services). An entity shall apply the little-or-no-cash criterion or other-assets criterion by considering the amount required to be paid by the holder relative to the end-of-period market price of the entity's common stock. For example, an entity would include in the denominator of basic EPS a warrant with an exercise price of $0.01 when the end-of-period market price of the common stock is $100 because the holder is deemed to have the present ability to become a common

shareholder. In the case of share-based-payment awards, the little-or-no-service criterion is met only if no further service is required to exercise the award.

4. A participating security (as defined in Statement 128 and clarified in EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128") might include, for example, an option, warrant, share-based-payment award (either vested or unvested[1]), or mandatorily convertible instrument. An entity shall include in the computation of basic EPS using the two-class method a participating security that is either:

a. Not measured at fair value each period with changes in fair value recognized in current-period earnings; or
b. A share-based-payment award that is recognized as equity.

A participating security that is measured at fair value each period with changes in fair value recognized in current-period earnings is not included in the computation of basic EPS using the two-class method. Similarly, a participating share-based-payment award that is recognized as a liability and measured at a fair-value-based amount under FASB Statement No. 123 (revised 2004), *Share-Based Payment,* is not included in the computation of basic EPS using the two-class method.

5. The preceding guidance amends paragraphs 8, 10, 60, and 64 and is added as paragraphs 9A and 60A of Statement 128. (See Appendix A.)

## Diluted Earnings per Share

### Instruments That Are Measured at Fair Value Each Period with Changes in Fair Value Recognized in Earnings

6. The objective of diluted EPS is to measure the performance of an entity over the reporting period while giving effect to all dilutive potential common shares outstanding during the period.

7. If a freestanding instrument (or a component of a compound instrument[2] that is accounted for as if it were freestanding) is measured at fair value[3] each period with changes in fair value recognized in earnings, the effect of that instrument on common shareholders during the period is reflected in the numerator of diluted EPS through the fair

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[1]FASB Staff Position (FSP) EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities,* provides guidance on when a nonvested share-based-payment award is a participating security. As a result, a share-based-payment award that is not currently exercisable may be included in basic EPS using the two-class method.

[2]For a convertible security, the *component of a compound instrument* refers only to the convertible component.

[3]Even though a share-based-payment award that is classified as a liability pursuant to Statement 123(R) is not measured at fair value (rather, it is measured at a fair-value-based amount), such an award is treated in a manner consistent with other instruments that are measured at fair value with changes in fair value recognized in earnings.

value changes recognized in earnings. Because the effect of that instrument on common shareholders during the period has been reflected in the numerator, an entity shall not increase the denominator for the number of additional common shares that would arise from the exercise or conversion of that instrument. Examples of that kind of instrument include the following:

a. Any instrument that is measured at fair value each period with changes in fair value recognized in earnings that would otherwise be subject to the treasury stock method, the reverse treasury stock method, the if-converted method, or the two-class method (for example, a freestanding written put option that is recognized as a liability and measured at fair value with changes in fair value recognized in earnings in accordance with FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*).
b. A share-based-payment award that is recognized (or that will be recognized) as a liability and measured at a fair-value-based amount under Statement 123(R). Even if the related compensation cost is not recognized in earnings for the current period (that is, if the related compensation cost is capitalized as part of the cost of an asset), it will be recognized in earnings in a future period. A share-based-payment award that is recognized as equity and measured at a fair-value-based amount each period (for example, a share-based-payment award issued to a nonemployee for which the measurement date, as defined in EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," has not occurred) shall be included in diluted EPS using the treasury stock method.

## Treasury Stock and Reverse Treasury Stock Methods

8. If an instrument classified as a liability is settled in common shares, an entity extinguishes that liability without sacrificing its assets. The extinguishment of that liability without the sacrifice of assets has the same effect on an entity's net assets as issuing shares in exchange for cash. Therefore, in applying the treasury stock method to compute diluted EPS, an entity shall include as assumed proceeds the end-of-period carrying value of a liability that is assumed to be share settled and that is not measured at fair value each period through earnings.

9. In applying the treasury stock and reverse treasury stock methods to compute diluted EPS, an entity shall use the end-of-period market price of common shares to determine the incremental number of shares to be included in the EPS denominator.

10. For purposes of applying the treasury stock method, an option or warrant (or its equivalent) is assumed to be exercised at the end of the period (or at the time of actual exercise, if earlier). The purchase of shares is assumed to occur at the end of the period using the end-of-period market price (or the market price at the time of actual exercise, if earlier). Accordingly, for purposes of applying the treasury stock method, exercise of an outstanding instrument and purchase of shares are assumed to occur on the last day of the reporting period (or at the time of actual exercise, if earlier). For purposes of applying the reverse treasury stock method, issuance of common shares and repurchase of shares

subject to the contract are assumed to occur on the last day of the reporting period (or at the time of actual exercise, if earlier).

11. The incremental number of shares shall be included in the computation of diluted EPS from the beginning of the period (or at the time the options or warrants are issued, if later). 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.

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

12. In computing diluted EPS for an instrument that can be settled in cash or common shares, an entity shall assume share settlement, if dilutive. That assumption (share settlement) may not be overcome, regardless of an entity's past practice or stated policy to the contrary. Share settlement shall be assumed for an otherwise cash-settled instrument that contains a provision that requires or permits share settlement under any circumstance, other than legal bankruptcy of the issuer.

## Quarterly and Year-to-Date Computations

13. An entity shall compute quarterly and year-to-date diluted EPS independently from any prior-period computation. Accordingly, the number of incremental shares used in computing quarterly and year-to-date diluted EPS shall be computed using the end-of-period market price of common shares for the period. An entity shall include a contingently issuable share in the computation of diluted EPS from the beginning of the quarterly and year-to-date periods, respectively, in which the conditions for issuance are satisfied (or at the date of the contingent share agreement, if later).

## Participating Securities

14. The difference between basic EPS and diluted EPS using the two-class method relates largely to the potential common shares or potential participating securities that are assumed to be outstanding. Paragraphs 11–35 of Statement 128 provide guidance for determining the common shares or participating securities assumed to be outstanding when computing diluted EPS.

15. An entity shall allocate undistributed earnings to all potential common shares or potential participating securities that are assumed to be outstanding for diluted EPS purposes. In doing so, an entity shall reallocate the undistributed earnings allocated to common shares or participating securities for purposes of basic EPS to give effect to the potential common shares or potential participating securities that are assumed to be outstanding for purposes of diluted EPS. In other words, an entity shall adjust the numerator for the undistributed earnings associated with the common shares or participating securities that are assumed to be outstanding. However, the entity shall not adjust the numerator for additional dividends that would be assumed to be declared for potential common shares or potential participating securities that are assumed to be outstanding.

16. For a participating security that is not measured at fair value each period with changes in fair value recognized in earnings that also is a potential common share, for a second class of common stock that also is a potential common share, or for a participating share-based-payment award that is recognized as equity, diluted EPS shall reflect the more dilutive effect of applying either:

a. The two-class method, assuming that the participating security or second class of common stock is not exercised or converted; or
b. The treasury stock method, reverse treasury stock method, if-converted method, or contingently issuable share method for the participating security or second class of common stock.

Consistent with paragraph 7, a participating security that is measured at fair value each period with changes in fair value recognized in earnings that also is a potential common share is not included in the computation of diluted EPS using the two-class method. Similarly, a participating share-based-payment award that is recognized as a liability and is measured at a fair-value-based amount under Statement 123(R) is not included in the computation of diluted EPS using the two-class method.

17. An entity shall compute diluted EPS for a second class of common stock assuming the exercise or conversion of all potential common shares (excluding the second class of common stock that is convertible into the first class of common stock) and potential participating securities. In other words, an entity shall determine the effect of reallocating undistributed earnings to other securities to determine what is available to the second class of common stock.

18. The computation of diluted EPS using the two-class method shall be performed for each potential common share in sequence from the most dilutive to the least dilutive. (See Illustrations 6A–6C of Appendix A [paragraph A5(f)] for an example of this provision.)

19. The preceding guidance amends paragraphs 17, 18, 21, 24, 29, 30, and 46–50 and is added as paragraphs 11A, 11B, 29A, and 61A–61E of Statement 128. (See Appendix A.)

## EFFECTIVE DATE AND TRANSITION

20. This Statement shall be effective for financial statements issued for fiscal years beginning after [date to be inserted after exposure], and interim periods within those fiscal years. Earlier application is prohibited. 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 paragraph 21.

21. Retrospective application is prohibited for instruments that on or before the last day of the period of adoption (including interim periods in the year of adoption) have been settled for cash or modified such that the instruments can no longer be settled in shares.

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

## Appendix A

## AMENDMENTS TO STATEMENT 128

A1. This appendix contains amendments to Statement 128. Certain paragraphs that are not affected by this Statement have been reproduced to provide context to the affected paragraphs.

A2. The guidance on basic EPS is amended as follows: [Added text is <u>underlined</u> and deleted text is ~~struck out~~.]

a. Paragraphs 8–10, as amended, and their related footnotes (paragraph 9 is provided for context):

### 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)[3] from income from continuing operations (if that amount appears in the income statement)[4] 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. 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. Illustration 7 in Appendix C provides an example of calculating EPS when there is a noncontrolling interest in a subsidiary in the consolidated group.

<u>9A. In addition to common shares outstanding, the computation of basic EPS shall include instruments for which the holder has (or is deemed to have) the present right as of the end of the period to share in current-period earnings with common shareholders. Examples of those instruments include the following:</u>

<u>a. An instrument that is currently exercisable for little or no cost to the holder</u>
<u>b. Shares that are currently issuable for little or no cost to the holder (paragraph 10)</u>

c. A **participating security** that is not measured at fair value each period with changes in fair value recognized in current-period earnings (paragraph 61)

d. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights (paragraph 61).

Shares issued during the period and shares reacquired during the period shall be weighted for the portion of the period that they were outstanding.

10. ~~Shares issuable for little or no cash consideration upon the satisfaction of certain conditions (**contingently issuable shares**)~~Instruments that are currently exercisable for little or no cost to the holder or shares that are currently issuable for little or no cost to the holder shall be considered outstanding common shares. Such instruments or shares shall be~~and~~ included in the computation of basic EPS as of the date the instrument becomes exercisable or the shares become issuable ~~that all necessary conditions have been satisfied (in essence, when issuance of the shares is no longer contingent)~~. For purposes of applying the little-or-no-cost criterion, cost refers to the amount required to be paid by the holder, whether in the form of cash, other assets, or services rendered (such as employee services). An entity shall apply the little-or-no-cash criterion or other-assets criterion by considering the amount required to be paid by the holder relative to the end-of-period market price of the entity's common stock. For example, an entity would include in the denominator of basic EPS a warrant with an exercise price of $0.01 when the end-of-period market price of the common stock is $100 because the holder is deemed to have the present ability to become a common shareholder. In the case of share-based-payment awards, the little-or-no-service criterion is met only if no further service is required to exercise the award. Outstanding common shares that are ~~contingently returnable (that is, subject to recall) shall be treated in the same manner as contingently issuable shares.~~~~[5]~~ subject to recall are not deemed to be outstanding and are excluded from the computation of basic EPS until the date the shares are no longer subject to recall. Outstanding common shares that are subject to recall may meet the definition of a participating security. If so, those shares shall be included in the computation of basic EPS using the two-class method (paragraph 61).

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[3]Preferred dividends that are cumulative only if earned shall be deducted only to the extent that they are earned.

[4]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.

~~[5]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.~~

A3. The guidance on diluted EPS is amended as follows:

a. Paragraphs 11−35, as amended, and their related footnotes (paragraphs 12−16, 19, 23, 25, 27, 28, and 31−35 are provided for context):

## Diluted Earnings per Share

11. 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.~~ 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 (a) any convertible preferred dividends and (b) 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.~~

### Instruments Measured at Fair Value Each Period with Changes in Fair Value Recognized in Earnings

11A. When a freestanding instrument (or a component of a compound instrument[5a] that is accounted for as if it were freestanding) is measured at fair value[5b] each period with changes in fair value recognized in earnings, the effect of that instrument on common shareholders during the period is reflected in the numerator of diluted EPS through the changes in fair value recognized in earnings. Because the effect of that instrument on common shareholders during the period has been reflected in the numerator, an entity shall not increase the denominator for the number of additional common shares that would arise from the exercise or conversion of that instrument. Examples of that kind of instrument include the following:

a. Any instrument that is measured at fair value each period with changes in fair value recognized in earnings that would otherwise be subject to the treasury stock method, the reverse treasury stock method, the if-converted method, or the two-class method (for example, a freestanding written put option that is recognized as a liability and measured at fair value with changes in fair value recognized in earnings in accordance with FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*).
b. A share-based-payment award that is recognized (or that will be recognized) as a liability and measured at a fair-value-based amount under FASB Statement No. 123 (revised 2004), *Share-Based Payment.*

Even if the related compensation cost is not recognized in earnings for the current period (that is, if it is capitalized as part of the cost of an asset), it will be recognized in earnings in a future period. A share-based-payment award that is recognized as equity and measured at a fair-value-based amount each period (for example, a share-based-payment award issued to a nonemployee for which the measurement date, as defined in EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," has not occurred) shall be included in diluted EPS using the treasury stock method.

## Instruments Not Measured at Fair Value Each Period with Changes in Fair Value Recognized in Earnings

11B. The computation of diluted EPS for instruments that are not measured at fair value each period with changes in fair value recognized in earnings or for share-based-payment awards that are recognized as equity 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 (a) any convertible preferred dividends and (b) the after-tax amount of interest expensed in the period associated with 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.

12. 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.

### *No Antidilution*

13. 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. 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.

14. 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.[6] Illustration 4 in Appendix C provides an example of that provision.

15. An entity that reports a discontinued operation or an extraordinary item in a period shall use income from continuing operations[7] (adjusted for preferred dividends as described in paragraph 9) 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.[8] (The control number excludes income from continuing operations attributable to the noncontrolling interest in subsidiaries.)

16. 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.

### *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, forward sale contracts, and partially paid stock subscriptions.[9] For purposes of computing the dilutive effect of options and warrants (and their equivalents) ~~U~~under the treasury stock method:

a. Options and warrants (and their equivalents), if dilutive, are assumed to be dilutive for the period they were outstanding. Options and warrants are assumed to be (1) outstanding from the beginning of the period (or at time of issuance, if later) and (2) exercised at the end of the period (or at time of actual exercise, if earlier).~~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~~end-of-period market price ~~during the period~~.[10] Included in assumed proceeds are:
   (1) The amount, if any, the holder must pay upon exercise
   (2) The end-of-period carrying amount of an option or warrant that is classified as a liability, that is not measured at fair value each period with changes in fair value recognized in earnings, and that would be extinguished upon exercise.

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 as of the beginning of the period (or at the time the options or warrants are issued, if later).[11]

18. Options and warrants will have a dilutive effect under the treasury stock method only when the ~~average~~end-of-period market price of the common stock ~~during the period~~(or the market price at the time of exercise, if earlier) 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(R)~~(revised 2004), *Share-Based Payment*~~) to be issued to an employee[12] 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~~the provision of future service. 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 end-of-period amount of compensation cost attributed to future services and not yet recognized,[13] and (c) the amount of excess tax benefits, if any, that would be credited to additional paid-in capital assuming exercise of the options as of the end of the period. Assumed proceeds shall not include compensation ascribed to past services. 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.

22. If share~~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 share~~stock~~-based awards are potential common shares shall be made based on the provisions in paragraph 29. If an entity has a tandem ~~plan [~~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~~cost 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.

**Written put options**

24. 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 21 and 22 of ~~FASB~~ Statement ~~No.~~ 150~~, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*,~~ shall be reflected in the computation of diluted EPS if the effect is dilutive. If those contracts are "in the money" ~~during~~as of the end of the reporting period (the exercise price is above the ~~average~~end-of-period 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~~end of the period (at the ~~average~~end-of-period market price~~during the period~~) to raise enough proceeds to satisfy the contract.
b. The proceeds from issuance shall be assumed to be used to satisfy the contract (that is, to buy back shares).
c. The incremental shares (the difference between the number of shares assumed issued and the number of shares received from satisfying the contract) shall be included in the denominator of the diluted EPS computation as of the beginning of the period (or at the time the options or warrants are issued, if later).[14]

**Purchased options**

25. 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.

## *Convertible Securities*

26. The dilutive effect of convertible securities, other than convertible securities that, by their stated terms, *require* the principal amount to be settled in cash (or other assets) upon conversion,[14a] 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.[15]
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[16] made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted, and (3) the numerator shall be adjusted for the income tax effect of (1) and (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.

27. 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.

28. 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.

### *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, ~~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.[17] It shall be presumed~~it shall be assumed 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.[17] ~~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 by 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 in shares does 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, and if the economic substance of an instrument is that of **contingently issuable shares,** it shall be accounted for under paragraphs 30–35.

### *Contingently Issuable Shares*

30. Contingently issuable ~~S~~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~~quarterly and year-to-date periods, respectively (or as of the date of the contingent stock agreement, if later).~~[18]~~

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.

31. 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. Illustration 3 in Appendix C provides an example of that provision.

32. 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.

33. 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.

34. 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. Illustration 3 in Appendix C provides an example of that provision.

35. 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 30–34.
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 17–25, the provisions for convertible securities in paragraphs 26–28, and the provisions for contracts that may be settled in stock or cash in paragraph 29, as appropriate.[19]

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.

[5a]For a convertible security, the *component of a compound instrument* refers only to the convertible component.

[5b]Even though a share-based-payment award that is classified as a liability pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, is not measured at fair value (rather, it is measured at a fair-value-based amount), such an award is treated in a manner consistent with other instruments that are measured at fair value with changes in fair value recognized in earnings.

[6]Options and warrants generally will be included first because use of the treasury stock method does not impact the numerator of the computation.

[6a][This footnote has been deleted because the effective date of FASB Statement No. 154, *Accounting Changes and Error Corrections,* has passed.]

[7]Refer to footnote 4.

[8]For example, assume that Corporation X 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. Corporation X'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. Corporation X would include the 200 potential common shares in the denominator of its diluted per-share computation for continuing operations because the resulting $2.00 per share is dilutive. (For illustrative purposes, assume no numerator impact of those 200 potential common shares.) Because income from continuing operations is the control number, Corporation X also must include those 200 potential common shares in the denominator for the other per-share amounts, even though the resulting per-share amounts [$(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.

[9]Refer to paragraph 64.

[10]Refer to paragraphs 21, 47, and 48.

[11]Consider Corporation Y that has 10,000 warrants outstanding exercisable at $54 per share; the ~~average~~end-of-period market price of the common stock ~~during~~for 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.

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 = [(end-of-period market price – exercise price)/end-of-period market price] × shares assumed issued under option; thus, [($60 – $54)/$60] × 10,000 = 1,000 incremental shares.

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

[13]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).

~~[14]For example, Corporation Z 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, Corporation Z 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.~~

[14a]Example 2 of EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," illustrates the manner in which convertible securities that, by their stated terms, require the principal amount to be settled in cash (or other assets) upon conversion should be reflected in diluted EPS.

[15]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 9.

[16]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.

[17]An example of such a contract is a ~~written put option~~convertible bond that gives the ~~holder~~issuer a choice of settling ~~in~~the bond's principal in any combination of common stock or ~~in~~ cash. Share~~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~~ paragraphs 29 and 29A.

~~[18]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.~~

[19]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.

A4. The computational guidance in Appendix A is amended as follows:

a. Paragraphs 46–53 and 59–64, as amended, and their related headings (paragraphs 51, 53, 59, and 63 are provided for context):

## Applying the Treasury Stock Method

### 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.~~ The number of incremental shares included in quarterly and year-to-date diluted EPS shall be computed using the end-of-period market price (or the market price at time of exercise, if earlier) 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 for its third quarter and nine-month year-to-date diluted EPS using the end-of-period market price of its common shares on September 30. Illustration 1 (Full Year 20X1, footnote a) in Appendix C provides an example of that provision.

### Average Market Price

~~47. 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.~~

~~48. 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.~~

## Options and Warrants and Their Equivalents

49. Options or warrants that are freestanding (or a component of a compound instrument that is accounted for as if it were freestanding) and that are not measured at fair value each period with changes in fair value recognized in earnings to purchase convertible securities shall be assumed to be exercised to purchase the convertible security whenever the ~~average~~end-of-period 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.

50. Paragraphs 51–53 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 (a) the effect is dilutive or (b) those instruments are freestanding (or a component of a compound instrument that is accounted for as if it were freestanding) and are not measured at fair value each period with changes in fair value recognized in earnings. Those potential common shares will have a dilutive effect if (~~a~~1) the ~~average~~end-of-period market price of the related common stock for the period exceeds the exercise price or (~~b~~2) 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. 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.

51. 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.

52. 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~~end-of-period 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).

53. 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.

## Business Combinations and Reorganizations

59. When common shares are issued to acquire a business in a business combination, the computations of earnings per share 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 Statement.

## Participating Securities and Two-Class Common Stock

### Basic EPS under the Two-Class Method

60. 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). A participating security might include, for example, an option, warrant, share-based-payment award (either vested or unvested), or mandatorily convertible instrument.
b. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

60A. An entity shall include in the computation of basic EPS using the two-class method a participating security, whether or not convertible into a class of common stock, that is either:

a. Not measured at fair value each period with changes in fair value recognized in earnings; or
b. A share-based-payment award that is recognized as equity.

A participating security that is measured at fair value each period with changes in fair value recognized in current-period earnings is not included in the computation of basic EPS using the two-class method. Similarly, a participating share-based-payment award that is recognized as a liability and measured at a fair-value-based amount under Statement 123(R) is not included in the computation of basic EPS using the two-class method.

61. ~~The if-converted method shall be used for those securities that are convertible into common stock if the effect is dilutive. For those securities that are not convertible into a class of common stock, the "two class" method of computing earnings per share shall be used.~~ The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under that 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).[25]
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 earnings per share 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.~~ Illustration 6 in Appendix C provides an example of ~~that provision~~the computation of basic EPS using the two-class method.

## Diluted EPS under the Two-Class Method

61A. The difference between basic EPS and diluted EPS using the two-class method relates largely to the potential common shares or potential participating securities that are assumed to be outstanding. Paragraphs 11–35 provide guidance for determining the common stock or participating securities assumed to be outstanding when computing diluted EPS. That guidance applies when using the two-class method to compute diluted EPS.

61B. An entity shall allocate undistributed earnings to all potential common shares or potential participating securities that are assumed to be outstanding. In doing so, an entity shall reallocate the undistributed earnings allocated to common shares or participating securities for purposes of basic EPS (paragraph 61(b)) to give effect to the potential common shares or potential participating securities assumed to be outstanding for purposes of diluted EPS. In other words, an entity shall adjust the numerator for the undistributed earnings associated with the common shares or participating securities that are assumed to be outstanding. However, the entity shall not adjust the numerator for additional dividends that would be assumed to be declared for the potential common shares or potential participating securities that are assumed to be outstanding.

61C. For a participating security that is not measured at fair value each period with changes in fair value recognized in earnings that also is a potential common share, for a second class of common stock that also is a potential common share, or for a participating share-based-payment award that is recognized as equity, diluted EPS shall reflect the more dilutive effect of applying either:

a. The two-class method assuming that the participating security or second class of common stock is not exercised or converted; or

b. The treasury stock method, reverse treasury stock method, if-converted method, or contingently issuable share method for the participating security or second class of common stock.

Consistent with paragraph 11A, a participating security that is measured at fair value each period with changes in fair value recognized in current-period earnings that is also a potential common share is not included in the computation of diluted EPS. Similarly, a participating share-based-payment award that is recognized as a liability and is measured at a fair-value-based amount under Statement 123(R) is not included in the computation of diluted EPS using the two-class method.

61D. An entity shall compute diluted EPS for a second class of common stock assuming the exercise or conversion of all potential common shares (excluding a second class of common stock that is convertible into the first class of common stock) and potential participating securities. In other words, an entity shall determine the effect of reallocating undistributed earnings to other securities to determine what is available to the second class of common stock.

61E. The computation of diluted EPS using the two-class method shall be performed for each potential common share in sequence from the most dilutive to the least dilutive. Illustrations 6A–6C in Appendix C (paragraph 155A) provide examples of the computation of diluted EPS using the two-class method.

## Securities of Subsidiaries

62. 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 company or common stock of the parent company. Unless freestanding securities (or a component of a compound security that is accounted for as if it were freestanding) are measured at fair value each period with changes in fair value recognized in earnings (see paragraph 11A), the~~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 company:

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. Illustration 7 in Appendix C provides an example of that provision.
b. Securities of a subsidiary that are convertible into its parent company’s common stock shall be considered among the potential common shares of the parent company for the purpose of computing consolidated diluted EPS. Likewise, a subsidiary’s options or warrants to purchase common stock of the parent company shall be considered among the potential common shares of the parent company in computing consolidated diluted EPS.~~ Illustration 7 in Appendix C provides an example of that provision.~~

As noted in paragraph 18 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* as amended by this Statement, the above provisions are applicable to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

63. The if-converted method shall be used in determining the EPS impact of securities issued by a parent company that are convertible into common stock of a subsidiary company or an investee company 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 26(a) and (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 company common stock outstanding would not change upon assumed conversion.

## Partially Paid Shares and Partially Paid Stock Subscriptions

64. If an entity has common shares issued in a partially paid form[27] 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<u>, using the two-class method,</u> to the extent that they were entitled to participate in dividends<u> (see paragraphs 61−61C)</u>. 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.

A5. Appendix C is amended as follows:

a. Paragraph 148, as amended, and its related footnotes:

**[For ease of use, only the portions of this paragraph affected by this Statement have been reproduced.]**

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 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~~End-of-period market price of common stock.* The ~~average~~end-of-period market prices of common stock for each quarter of 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.~~

*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.

Corporation A issued the following instruments in 20X0 and 20X1. These instruments are not measured at fair value each period with changes in fair value recognized in earnings.

*Convertible debentures.* In the last quarter of 20X0, 10,000 4 percent convertible debentures with ~~a~~an aggregate principal amount of $10,000,000 due in 20 years were sold at $1,000 (par) 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, when the market price of common stock before the exercise was $71.

*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.

| Year 20X1 | Income (Loss) before Extraordinary Item[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). Refer to paragraph 15.
[b]Corporation A had a $2 million extraordinary loss (net of tax) in the third quarter.
[c][This footnote has been deleted because the effective date of Statement 154 has passed.]

## 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 | 0[c] | |
| Convertible preferred stock | 600,000 | |
| 4% convertible debentures | 200,000 | |
| **Dilutive potential common shares** | | 800,000 |
| Adjusted weighted-average shares | | 4,133,333 |

**Diluted EPS $0.74**

The equation for computing diluted EPS is:

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

[a]600,000 shares × $0.05
[b]($10,000,000 × 4%) ÷ 4; less taxes at 40%
[c]The warrants were not assumed exercised because they were antidilutive in the period ($60 exercise price > $59 ~~average~~end-of-period market price).

**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 |
| Extraordinary item | | | (2,000,000) |
| Net income available to common stockholders + assumed conversions | | | $5,560,000 |
| | | | |
| **Weighted-average shares** | | | 3,991,666 |
| Plus: Incremental shares from assumed conversions | | | |
| Warrants | | 51,643 ~~30,768~~ [a] | |
| Convertible preferred stock | | 308,333[b] | |
| 4% convertible debentures | | 50,000[c] | |
| **Dilutive potential commons shares** | | | 409,976 ~~389,101~~ |
| Adjusted weighted-average shares | | | 4,401,642 ~~4,380,767~~ |

**Diluted EPS**

| | |
|---|---|
| Income before extraordinary item | **$ ~~1.73~~ 1.72** |
| Extraordinary item | **$(0.46)** |
| Net income | **$ ~~1.27~~ 1.26** |

The equation for computing diluted EPS is:

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

[a] ~~(71,429 shares × 3/12) + (51,643 shares × 3/12)~~[($71 − $60) ÷ $71] × 500,000 shares = 77,465 shares; 77,465 shares × (8/12) = 51,643 shares

[b] (600,000 shares × 5/12) + (100,000 shares × 7/12)

[c] 200,000 shares × 3/12

b. Paragraph 151, as amended:

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~~stock~~-based compensation arrangements.

| | For the Year Ended 20X1 | | |
|---|---|---|---|
| | **Income (Numerator)** | **Shares (Denominator)** | **Per-Share Amount** |
| Income before extraordinary item ~~and accounting change~~ | $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~~ 51,643 | |
| Convertible preferred stock | 45,000 | 308,333 | |
| 4% convertible debentures | 60,000 | 50,000 | |
| **Diluted EPS** | | | |
| Income available to common stockholders + assumed conversions | $7,560,000 | ~~4,380,767~~ 4,401,642 | $~~1.73~~ 1.72 |

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~~end-of-period market price of the common shares. The options, which expire on June 30, 20Y1, were still outstanding at the end of year 20X1.

c. Paragraph 152 and its related footnotes:

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 period, year-to-date period, 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.~~

| Basic EPS Computation | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year |
|---|---|---|---|---|---|
| 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 |

| Diluted EPS Computation | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year |
|---|---|---|---|---|---|
| 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~~ 2,000[e] |
| Earnings contingency | 0[f] | 5,000[g] | 0[h] | 10,000[i] | ~~3,750~~ 10,000[j] |
| Total shares | 100,000 | 106,000 | 102,000 | 112,000 | ~~105,000~~ 112,000 |
| Diluted EPS | $ 4.00 | $ 1.89 | $ (1.47)[k] | $ 2.23 | $ ~~6.67~~ 6.25 |

---

[a] 1,000 shares × 2/3

[b] 1,000 shares + (1,000 shares × 1/3)

[c] (1,000 shares × 8/12) + (1,000 shares × 4/12)

[d] The earnings contingency has no effect on basic EPS because it is not certain that the condition is satisfied until the end of the contingency period (paragraphs 10 and 31). The effect is negligible for the fourth-quarter and full-year computations because it is not certain the condition is met until the last day of the period.

[e] ~~(0 + 1,000 + 2,000 + 2,000) ÷ 4~~1,000 shares + 1,000 shares

[f] 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.

[g] [($600,000 – $500,000) ÷ $100] × 5 shares

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

[i] [($700,000 – $500,000) ÷ $100] × 5 shares

[j] ~~(0 + 5,000 + 0 + 10,000) ÷ 4~~[($700,000 − $500,000) ÷ $100] × 5 shares

[k] Loss during the third quarter is due to an extraordinary item~~a change in accounting principle~~; therefore, antidilution rules (paragraph 15) do not apply.

d. Paragraph 153:

**[For ease of use, only the portions of this paragraph affected by this Statement have been reproduced.]**

The following example illustrates the antidilution sequencing provisions described in paragraph 14 for Corporation C for the year ended December 31, 20X0. The facts assumed are as follows:

- Corporation C had income available to common stockholders of $10,000,000 for the year 20X0.
- 2,000,000 shares of common stock were outstanding for the entire year 20X0.
- The ~~average~~end-of-period market price of the common stock was $75.
- Corporation C had the following potential common shares outstanding during the year:
  - Options (not compensation related) to buy 100,000 shares of common stock at $60 per share.
  - 800,000 shares of convertible preferred stock entitled to a cumulative dividend of $8 per share. Each preferred share is convertible into 2 shares of common stock.
  - 5 percent convertible debentures with a principal amount of $100,000,000 (issued at par). Each $1,000 debenture is convertible into 20 shares of common stock.
- The tax rate was 40 percent for 20X0.

e. Paragraph 155 and the heading that precedes it:

## Illustration 6—Basic EPS under the Two-Class Method

The two-class method of computing basic EPS ~~for an entity that has more than one class of nonconvertible securities~~ is illustrated in the following example. This method is described in paragraph 61~~; as noted in that paragraph, diluted EPS would be computed in a similar manner~~. The facts assumed for the year 20X0 are as follows:

- Net income was $65,000.
- 10,000 shares of $50 par value common stock were outstanding.
- 5,000 shares of $100 par value nonconvertible preferred stock were outstanding.
- The preferred stock was entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock.
- After common stock has been paid a dividend of $2 per share, the preferred stock then participates in any additional dividends on a 40:60 *per-share* ratio with common stock. (That is, after preferred and common stock have been paid dividends of $5 and $2 per share, respectively, preferred stock

participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)

- Preferred stockholders have been paid $27,000 ($5.40 per share).
- Common stockholders have been paid $26,000 ($2.60 per share).

Basic EPS for 20X0 would be computed as follows:

| | | |
|---|---|---|
| Net income | | $65,000 |
| Less dividends paid: | | |
| Preferred | $27,000 | |
| Common | 26,000 | (53,000) |
| Undistributed 20X0 earnings | | $12,000 |

Allocation of undistributed earnings:

*To preferred:*

0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $3,000
$3,000 ÷ 5,000 shares = $0.60 per share

*To common:*

0.6(10,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $9,000
$9,000 ÷ 10,000 shares = $0.90 per share

**Basic per-share amounts:**

| | Preferred Stock | Common Stock |
|---|---|---|
| Distributed earnings | $5.40 | $2.60 |
| Undistributed earnings | 0.60 | 0.90 |
| Totals | $6.00 | $3.50 |

f. Paragraph 155A and its related headings are added as follows:

## Illustration 6A—Diluted EPS under the Two-Class Method

The two-class method for computing diluted EPS is illustrated in the following three scenarios. The method to compute diluted EPS under the two-class method is described in paragraph 61A of this Statement. The facts assumed for the year 20X1 are as follows:

### Scenario 1—Common Stock with Participating Preferred Security

- Net income was $65,000.
- 10,000 shares of common stock were outstanding.
- 5,000 shares of nonconvertible preferred stock were outstanding.
- The preferred stock is entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common stock.
- After the common stock has been paid a dividend of $2 per share, the preferred stock participates in any additional dividends on a 40:60 per-share ratio with common stock. (That is, after the preferred and the common stock have been paid dividends of $5 and $2 per share, respectively, the preferred stock participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)
- Preferred stockholders have been paid $27,000 ($5.40 per share).
- Common shareholders have been paid $26,000 ($2.60 per share).
- On January 1, 20X1, the company issued the following instruments. These instruments are not measured at fair value each period with changes in fair value recognized in earnings.
  – 1,000 30-year convertible bonds with an aggregate par value of $1,000,000. Each bond is convertible into 8 shares of common stock and carries a coupon rate of 3 percent.
  – Options to employees to purchase 2,000 shares of common stock at $50 per share. The end-of-period market price of the company's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff vesting). The company expects all of the option awards to vest.
- The tax rate was 40 percent for 20X1.

## ***Basic EPS for 20X1 under the Two-Class Method***

| | | |
|---|---|---|
| Net income | | $65,000 |
| Less dividends paid: | | |
| Preferred | $27,000 | |
| Common | 26,000 | |
| | | 53,000 |
| Undistributed 20X1 earnings | | $12,000 |

Allocation of undistributed earnings:

*To preferred:*

0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $3,000

$3,000 ÷ 5,000 shares = $0.60 per share

*To common:*

0.6(10,000) ÷ [0.4(5,000) + 0.6(10,000)] × $12,000 = $9,000

$9,000 ÷ 10,000 shares = $0.90 per share

**Basic EPS amounts:**

| | **Preferred Stock** | **Common Stock** |
|---|---|---|
| Distributed earnings | $5.40 | $2.60 |
| Undistributed earnings | 0.60 | 0.90 |
| Totals | $6.00 | $3.50 |

## ***Diluted EPS for 20X1 under the Two-Class Method***

*Antidilution Sequencing*

| | **Increase in Earnings Available to Common Shareholders** | **Increase in Number of Common Shares** | **Earnings per Incremental Share** |
|---|---|---|---|
| Options | — | 142[a] | — |
| Convertible bonds | $18,000[b] | 8,000[b] | $2.25 |

*Calculation of Diluted EPS Assuming the Use of the Two-Class Method*

| | **Undistributed and Distributed Earnings to Common Shareholders** | **Common Shares** | **Earnings per Share** |
|---|---|---|---|
| As reported—basic | $35,000[c] | 10,000 | $3.50 |
| Add-back: Undistributed earnings allocated to preferred shares | 3,000 | — | |
| Options | — | 142[a] | |
| Less: Undistributed earnings reallocated to preferred shares | (2,968)[d] | — | |
| Subtotal | 35,032 | 10,142 | $3.45 |
| Add-back: Undistributed earnings allocated to preferred shares | 2,968 | — | |
| Convertible bonds | 18,000[b] | 8,000[b] | |
| Less: Undistributed earnings reallocated to preferred shares | (4,657)[e] | — | |
| **Diluted EPS for common stock** | **$51,343** | **18,142** | **$2.83** |

[a]Incremental shares outstanding from assumed exercise of the outstanding options:

| | |
|---|---|
| Exercise price | $50 × 2,000 = $100,000 |
| End-of-period unrecognized compensation cost | {[($5 × 2,000) ÷ 4-year service period] × 3 remaining years of service}= $7,500 |
| Excess tax benefit | {[($60 − $50) − $5] × 2,000} × 40% = $4,000 |
| Shares repurchased | $111,500 ÷ $60 = 1,858 |
| Incremental shares | 2,000 − 1,858 = 142 shares |

[b]Assumed conversion of the convertible bonds would result in 8,000 incremental shares and the add-back of $18,000 ([$1,000,000 × 3% × (1 − .4)] = $18,000) in after-tax interest expense to undistributed earnings for the period.

[c]Amount represents the aggregate of the distributed ($26,000) and undistributed earnings ($9,000) allocated to the common shareholders.

[d]Reallocation of undistributed earnings = 0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000 + 142)] × $12,000 undistributed earnings = $2,968

[e]0.4(5,000) ÷ [0.4(5,000) + 0.6(10,000 + 142 + 8,000)] × ($12,000 undistributed earnings + $18,000 interest add-back) = $4,657

## Scenario 2—Two Classes of Common Stock with Different Dividend Rights; One Class Convertible into the Other

- Net income was $65,000.
- 10,000 shares of Class A common stock were outstanding.
- 10,000 shares of Class B common stock were outstanding.
- Each share of Class B common stock is convertible into one share of Class A common stock.
- Class B shareholders receive 95 percent of any dividends declared on Class A common stock on a per-share basis.
- Class A shareholders have been paid $10,000 ($1.00 per share).
- Class B shareholders have been paid $9,500 ($0.95 per share).
- On January 1, 20X1, the company granted options to employees to purchase 2,000 shares of Class A common stock at $50 per share. The options are not measured at fair value each period with changes in fair value recognized in earnings. The end-of-period market price of the company's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff vesting). The company expects all of the option awards to vest.
- The tax rate was 40 percent for 20X1.

### *Basic EPS for 20X1 under the Two-Class Method*

| | | |
|---|---|---|
| Net income | | $65,000 |
| Less dividends paid: | | |
| Class A | $10,000 | |
| Class B | 9,500 | 19,500 |
| Undistributed 20X1 earnings | | $45,500 |

Allocation of undistributed earnings:

*To Class A:*

1.0(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $23,333

$23,333 ÷ 10,000 shares = $2.33 per share

*To Class B:*

0.95(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $22,167

$22,167 ÷ 10,000 shares = $2.22 per share

**Basic EPS amounts:**

| | **Class A** | **Class B** |
|---|---|---|
| Distributed earnings | $1.00 | $0.95 |
| Undistributed earnings | 2.33 | 2.22 |
| Total | $3.33 | $3.17 |

***Diluted EPS for 20X1 under the Two-Class Method for Class A Shares***

*Antidilution Sequencing*

| | Increase in Earnings Available to Class A Common Shareholders | Increase in Number of Class A Common Shares | Earnings per Incremental Share |
|---|---|---|---|
| Options | — | 142[a] | — |
| Class B conversion | $31,667[b] | 10,000 | $3.17 |

*Calculation of Diluted EPS for Class A Assuming the Use of the Two-Class Method and That Class B Does Not Convert*

| | Undistributed and Distributed Earnings to Class A Common Shareholders | Class A Common Shares | Earnings per Share |
|---|---|---|---|
| As reported—basic | $33,333[c] | 10,000 | $3.33 |
| Add-back: Undistributed earnings allocated to Class B shares | 22,167 | — | |
| Options | — | 142[a] | |
| Less: Undistributed earnings reallocated to Class B shares | (22,006)[d] | — | |
| **Diluted EPS for Class A common stock** | **$33,494** | **10,142** | **$3.30** |

*Calculation of Diluted EPS for Class A Assuming the Use of the If-Converted Method for Class B*

| | **Undistributed and Distributed Earnings to Class A Common Shareholders** | **Class A Common Shares** | **Earnings per Share** |
|---|---|---|---|
| As reported—basic | $33,333[c] | 10,000 | $3.33 |
| Options | — | 142[a] | |
| Subtotal | 33,333 | 10,142 | $3.29 |
| Class B conversion | 31,667[b] | 10,000 | |
| **Diluted EPS for Class A common stock** | **$65,000** | **20,142** | **$3.23** |

***Diluted EPS for 20X1 under the Two-Class Method for the Class B Shares***

| | **Undistributed and Distributed Earnings to Class B Common Shareholders** | **Class B Common Shares** | **Earnings per Share** |
|---|---|---|---|
| As reported—basic | $31,667[b] | 10,000 | $3.17 |
| Less: Undistributed earnings allocated to Class B shares | (22,167) | | |
| Add-back: Undistributed earnings reallocated to Class B shares | 22,006[d] | — | |
| **Diluted EPS for Class B common stock** | **$31,506** | **10,000** | **$3.15** |

[a]Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:

| | |
|---|---|
| Exercise price | $50 × 2,000 = $100,000 |
| End-of-period unrecognized compensation cost | {[($5 × 2,000) ÷ 4 year service period] × 3 remaining years of service}= $7,500 |
| Excess tax benefit | {[($60 − $50) − $5] × 2,000} × 40% = $4,000 |

| | |
|---|---|
| Shares repurchased | $\$111{,}500 \div \$60 = 1{,}858$ |
| Incremental Class A shares | $2{,}000 - 1{,}858 = 142$ shares |

[b]Amount represents the aggregate of the distributed ($9,500) and undistributed earnings ($22,167) allocated to the Class B common shareholders in the basic EPS computation.
[c]Amount represents the aggregate of the distributed ($10,000) and undistributed earnings ($23,333) allocated to the Class A common shareholders.
[d]Reallocation of undistributed earnings = $0.95(10{,}000) \div [1.0(10{,}000 + 142) + 0.95(10{,}000)] \times \$45{,}500$ total undistributed earnings = $22,006

**Note:** In this scenario, the company would disclose diluted EPS per Class A shares using the if-converted method ($3.23) because that amount is more dilutive than the result yielded from the two-class method ($3.30). The company also would disclose the fact that diluted earnings per Class A shares assumes conversion of Class B shares into Class A shares because the effect is dilutive. Diluted earnings per Class B shares would be disclosed as $3.15, as determined by the two-class method above.

## Scenario 3—Two Classes of Common Stock with Different Dividend Rights; One Class Convertible into the Other and Convertible Bonds Outstanding

- Net income was $65,000.
- 10,000 shares of Class A common stock were outstanding.
- 10,000 shares of Class B common stock were outstanding.
- Each share of Class B common stock is convertible into one share of Class A common stock.
- Class B shareholders receive 95 percent of any dividends declared on Class A common stock on a per-share basis.
- Class A shareholders have been paid $10,000 ($1.00 per share).
- Class B shareholders have been paid $9,500 ($0.95 per share).
- On January 1, 20X1, the company issued the following instruments. These instruments are not measured at fair value each period with changes in fair value recognized in earnings.
  - Options to employees to purchase 2,000 shares of Class A common stock at $50 per share. The end-of-period market price of the company's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff vesting). The company expects all of the option awards to vest.
  - 500 30-year convertible bonds with an aggregate par value of $500,000. Each bond is convertible into 20 shares of Class A common stock (10,000 shares in total) and carries a coupon rate of 3 percent.
- The tax rate was 40 percent for 20X1.

***Basic EPS for 20X1 under the Two-Class Method***

| | | |
|---|---|---|
| Net income | | $65,000 |
| Less dividends paid: | | |
| Class A | $10,000 | |
| Class B | 9,500 | 19,500 |
| Undistributed 20X1 earnings | | $45,500 |

Allocation of undistributed earnings:

*To Class A:*

1.0(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $23,333

$23,333 ÷ 10,000 shares = $2.33 per share

*To Class B:*

0.95(10,000) ÷ [1.0(10,000) + 0.95(10,000)] × $45,500 = $22,167

$22,167 ÷ 10,000 shares = $2.22 per share

**Basic EPS amounts:**

| | **Class A** | **Class B** |
|---|---|---|
| Distributed earnings | $1.00 | $0 .95 |
| Undistributed earnings | 2.33 | 2.22 |
| Total | $3.33 | $3.17 |

***Diluted EPS for 20X1 under the Two-Class Method for the Class A Shares***

*Antidilution Sequencing*

| | **Increase in Earnings Available to Class A Common Shareholders** | **Increase in Number of Class A Common Shares** | **Earnings per Incremental Share** |
|---|---|---|---|
| Options | — | 142[a] | — |
| Convertible bonds | $9,000[b] | 10,000[b] | $0.90 |
| Class B conversion | $31,667[c] | 10,000 | $3.17 |

*Calculation of Diluted EPS for Class A Assuming the Use of the Two-Class Method and That Class B Does Not Convert*

| | **Undistributed and Distributed Earnings to Class A Common Shareholders** | **Class A Common Shares** | **Earnings per Share** |
|---|---|---|---|
| As reported—basic | $33,333[d] | 10,000 | $3.33 |
| Add-back: Undistributed earnings allocated to Class B shares | 22,167 | — | |
| Options | — | 142[a] | |
| Less: Undistributed earnings reallocated to Class B shares | (22,006)[e] | — | |
| Subtotal | 33,494 | 10,142 | $3.30 |
| Add-back: Undistributed earnings allocated to Class B shares | 22,006 | — | |
| Convertible bonds | 9,000[b] | 10,000[b] | |
| Less: Undistributed earnings reallocated to Class B shares | (17,467)[f] | — | |
| **Diluted EPS for Class A common stock** | **$47,033** | **20,142** | **$2.34** |

*Calculation of Diluted EPS for Class A Assuming the Use of the If-Converted Method for Class B*

| | **Undistributed and Distributed Earnings to Class A Common Shareholders** | **Class A Common Shares** | **Earnings per Share** |
|---|---|---|---|
| As reported—basic | $33,333[d] | 10,000 | $3.33 |
| Options | — | 142[a] | |
| Subtotal | 33,333 | 10,142 | $3.29 |
| Convertible bonds | 9,000[b] | 10,000[b] | |
| | 42,333 | 20,142 | $2.10 |
| Class B Conversion | 31,667[c] | 10,000 | |
| **Diluted EPS for Class A common stock** | **$74,000** | **30,142** | **$2.46** |

### ***Diluted EPS for 20X1 under the Two-Class Method for the Class B shares***

| | **Undistributed and Distributed Earnings to Class B Common Shareholders** | **Class B Common Shares** | **Earnings per Share** |
|---|---|---|---|
| As reported—basic | $31,667[c] | 10,000 | $3.17 |
| Less: Undistributed earnings to Class B shares | (22,167) | — | |
| Add-back: Undistributed earnings reallocated to Class B shares | 17,467[f] | | |
| **Diluted EPS for Class B common stock** | **$26,967** | **10,000** | **$2.70** |

---

[a]Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:

| | |
|---|---|
| Exercise price | $50 × 2,000 = $100,000 |
| End-of-period unrecognized compensation cost | {[($5 × 2,000) ÷ 4 year service period] × 3 remaining years of service}= $7,500 |

| | |
|---|---|
| Excess tax benefit | {[($60 − $50) − $5] × 2,000} × 40% = $4,000 |
| Shares repurchased | $111,500 ÷ $60 = 1,858 |
| Incremental shares | 2,000 − 1,858 = 142 shares |

[b]Assumed conversion of the convertible bonds would result in 10,000 incremental shares and the add-back of $9,000 [$500,000 × 3% × (1 − 0.4)] in after-tax interest expense to undistributed earnings for the period.
[c]Amount represents the aggregate of the distributed ($9,500) and undistributed earnings ($22,167) allocated to the Class B common shareholders in the basic EPS computation.
[d]Amount represents the aggregate of the distributed ($10,000) and undistributed earnings ($23,333) allocated to the Class A common shareholders.
[e]Reallocation of undistributed earnings = 0.95(10,000) ÷ [1.0(10,000 + 142) + 0.95(10,000)] × $45,500 undistributed earnings = $22,006
[f]Reallocation of undistributed earnings = 0.95(10,000) ÷ [1.0(10,000 + 142 + 10,000) + 0.95(10,000)] × ($45,500 undistributed earnings + $9,000 interest add-back) = $17,467

**Note:** In this scenario, the company would disclose diluted EPS per Class A shares using the two-class method ($2.34) because the assumed conversion of Class B shares using the if-converted method ($2.46) is less dilutive than the result yielded from the two-class method. Diluted earnings per Class B shares would be disclosed as $2.70, as determined by the two-class method above.

g. Paragraph 156, as amended:

**[For ease of use, only the portions of this paragraph affected by this Statement have been reproduced.]**

The following 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 62. The facts assumed are as follows:

Parent corporation:

- Net income was $10,000 (excluding any earnings of or dividends paid by the subsidiary).
- 10,000 shares of common stock were outstanding; the parent corporation had not issued any other securities.
- The parent corporation owned 900 common shares of a domestic subsidiary corporation.
- The parent corporation owned 40 warrants issued by the subsidiary.
- The parent corporation owned 100 shares of convertible preferred stock issued by the subsidiary.

Subsidiary corporation:

- Net income was $3,600.
- 1,000 shares of common stock were outstanding.
- Warrants that are not measured at fair value each period with changes in fair value recognized in earnings exercisable to purchase 200 shares of its common stock at $10 per share (assume $20 ~~average~~end-of-period market price for common stock) were outstanding.
- 200 shares of convertible preferred stock were outstanding. Each share is convertible into two shares of common stock.
- The convertible preferred stock paid a dividend of $1.50 per share.
- No intercompany eliminations or adjustments were necessary except for dividends.
- Income taxes have been ignored for simplicity.

h. Paragraph 157, as amended:

Under this Statement, options, other than those recognized as a liability and measured at a fair-value-based amount under Statement 123(R), to be settled in stock are potential common shares for purposes of earnings per share computations. 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 earnings per share. The proceeds assumed to be received upon exercise include the exercise price that the employee pays, the end-of-period amount of compensation cost measured and attributed to future services and thus ~~but~~ not yet recognized, and the amount of any tax benefits upon assumed exercise as of the end of the period that would be credited to additional paid-in capital. If a~~the~~ deferred tax asset related to the option exceeds the tax benefit that would be received if the option was exercised and that ~~resulting~~ difference would be deducted from additional paid-in capital (or its equivalent) ~~assuming exercise of the options~~, that amount shall be treated as a reduction of assumed proceeds.

i. Paragraph 159, as amended:

Entity L adopted a share option plan on January 1, 20X7, and granted 900,000 at-the-money share options with an exercise price of $30.[a] All share options vest at the end of three years (cliff vesting). At the grant date, Entity L assumes an annual forfeiture rate of 3 percent and therefore expects to receive the requisite service for 821,406 [900,000 × (.97$^3$)] share options. On January 1, 20X7, the fair value of each share option granted is $14.69. Employees forfeited 15,000 stock options ratably during 20X7. The ~~average stock~~end-of-period market price during 20X7 is $44. Net income for the period is $97,385,602 (inclusive of $2,614,398 of share-based compensation, net of income taxes of $1,407,753). Entity L's tax rate is 35 percent. For the year ended December 31, 20X7, there are 25,000,000 weighted-average common shares outstanding. Entity L has sufficient previously recognized excess tax benefits in additional paid-in capital from prior share-based payment arrangements to offset any write-off of deferred tax assets associated with its grant of share options on January 1, 20X7. All share options are the type that upon exercise give rise to deductible compensation cost for income tax purposes.

**Computation of Basic EPS for the Year Ended December 31, 20X7:**

| | |
|---|---|
| Net income[b] | $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~~end-of-period number of options outstanding were exercised ~~using the average exercise price~~ (~~892,500~~885,000[c] × $30) | $26,550,000~~26,775,000~~ |
| End-of-period~~Average~~ unrecognized compensation cost in 20X7 (see computation) | 8,667,100~~10,944,050~~ |
| Tax benefit deficiency that would be offset in paid-in capital (see computation) | (213,728)~~(215,539)~~ |
| Assumed proceeds | $35,003,372 ~~$37,503,511~~ |

**Computation of end-of-period~~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 (900,000 × $14.69) | ~~$13,221,000~~ | $13,221,000 |

| | | |
|---|---|---|
| Annual compensation cost recognized during 20X7, based on estimated forfeitures | (4,022,151)[b] | |
| 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)[d] | |
| Total compensation cost of actual forfeited options | (220,350)[e] | |
| Total unrecognized compensation cost, end of the period, based on actual forfeitures | | $8,667,100[f] |
| ~~Subtotal~~ | | ~~21,888,100~~ |
| ~~Average total unrecognized compensation, based on actual forfeitures~~ | | ~~$10,944,050~~ |

**Computation of tax benefit:**

| | |
|---|---|
| Total compensation cost of end-of-period~~average~~ outstanding options | $13,000,650 ~~$13,110,825~~[fg] |
| Intrinsic value of ~~average~~ outstanding options as of~~for~~ the year ended December 31, 20X7 [885,000 ~~892,500~~ × ($44 − $30)] | (12,390,000) ~~(12,495,000)~~ |
| Excess of total compensation cost over estimated tax deduction | 610,650 ~~615,825~~ |
| Tax benefit deficiency ($610,650~~$615,825~~ × .35) | $213,728 ~~$215,539~~ |

**Assumed repurchase of shares:**

| | |
|---|---|
| Repurchase shares at ~~average~~end-of-period market price ~~during the year~~ ($35,003,372 ~~$37,503,511~~ ÷ $44) | 795,531 ~~852,353~~ |
| Incremental shares (885,000~~892,500~~ – 795,531~~852,353~~) | 89,469 ~~40,147~~ |

**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 | 89,469 ~~40,147~~ |
| Total shares outstanding | 25,089,469 ~~25,040,147~~ |
| Diluted earnings per share | $3.88 ~~$3.89~~ |

---

[a] This guidance also applies if the service inception date precedes the grant date.

[b] Pre-tax annual share-based compensation cost is $4,022,151 [(821,406 × $14.69) ÷ 3]. After-tax share-based compensation cost included in net income is $2,614,398 ($4,022,151 – $1,407,753). ($4,022,151 × .35) = $1,407,753.

[c]Share options ~~granted at the beginning of the year plus share options~~ outstanding at the end of the year (900,000 – 15,000) = 885,000~~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~~.

[d]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).

[e]15,000 (forfeited options) × $14.69 (grant-date fair value per option) = $220,350 (total fair value).

[f]~~(892,500 × $14.69) = $13,110,825.~~A shortcut formula for this computation is {[885,000 (options outstanding at the end of the year) × $14.69] ÷ 3} × 2 (years of service remaining).

[fg](885,000 × $14.69) = $13,000,650

A6. Paragraph 171 (glossary) is amended as follows:

**[For ease of use, only the portions of this paragraph affected by this Statement have been reproduced.]**

**Contingently issuable shares (contingently issuable stock)**

Shares whose issuance is contingent~~issuable for little or no cash consideration~~ upon the satisfaction of certain conditions pursuant to a contingent stock agreement. Refer to **contingent stock agreement.**

**Participating security**

A security that may participate in current-period earnings with common stock 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), whether or not that participation is conditioned upon the occurrence of a specified event. See EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," for additional guidance on determining whether a security is a participating security.

**Reverse treasury stock method**

A method of recognizing the dilutive effect on earnings per share 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~~end-of-period market price~~ during the period~~. Refer to **put option.**

**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~~end-of-period market price ~~during the period~~.

# Appendix B

## BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS

## Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this proposed Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

B2. In September 2002, the FASB and the IASB made a commitment to converge the accounting standards of their respective jurisdictions through a long-term convergence plan that would include joint major projects to develop new, common standards and projects that would reduce or eliminate narrow differences between certain of their accounting standards (so-called short-term convergence projects). The Boards acknowledged that they also might seek to make minor improvements to the existing accounting literature as part of the short-term convergence projects. Both Boards agreed to limit the scope of the narrower convergence projects to issues outside of the scope of an active major project for which convergence to a high-quality solution appeared achievable in the near term, usually by selecting between provisions of the existing standards of the FASB or the IASB.

B3. The FASB began work on a short-term convergence project on EPS in 2002. The Board issued two Exposure Drafts (titled *Earnings per Share*), the first in December 2003 and the second in September 2005, for a 120-day and a 60-day comment period, respectively. The Board received 29 comment letters on the 2003 Exposure Draft and 14 comment letters on the 2005 Exposure Draft. Most of the conclusions and considerations from the 2003 and 2005 Exposure Drafts were affirmed in redeliberations. However, the Board concluded that certain additional decisions made during redeliberations warranted reexposure. This appendix addresses decisions made during the deliberations and redeliberations of the 2003 and 2005 Exposure Drafts.

B4. The amendments in this proposed Statement are focused on achieving convergence by arriving at the same EPS denominator under both U.S. GAAP and IFRS. A related objective is to clarify and simplify the computation of EPS by excluding from the computation of diluted EPS certain freestanding instruments (or a component of certain compound instruments that is accounted for as if it were freestanding) that are measured at fair value each period with changes in fair value recognized in earnings.

## Computation of Basic EPS

### Shares That Can Be Issued for Little or No Cost

B5. The Board observed that there may be questions about when an instrument with a very low exercise price should be included in basic EPS. The Board agreed that basic EPS reflects the allocation of current-period earnings to common shareholders. The Board agreed that including an instrument in basic EPS that does not give the holder the present ability to become a common shareholder provides an inaccurate depiction that, in all cases, the holder has the same claim to current-period earnings as a common shareholder even if the holder has stated participation rights that differ from common shareholders. Accordingly, the Board decided that the holder of (a) an instrument that is currently exercisable for little or no cost to the holder or (b) a share that is currently issuable for little or no cost to the holder has the present ability to become a common shareholder and, therefore, has the present right to share in current-period earnings with common shareholders. That is, such an instrument or share represents an in-substance common share. The Board decided not to characterize such an instrument or share as an *in-substance common share* in this proposed Statement to prevent confusion with other GAAP that uses that term in a different context.

### Mandatorily Convertible Instruments

B6. IAS 33 requires that all mandatorily convertible instruments be included in the computation of basic EPS, though it does not prescribe the method to be used. Statement 128 does not have a similar requirement. The 2005 Exposure Draft proposed that shares issuable upon conversion of a mandatorily convertible instrument be included in the computation of basic EPS from the date that future conversion becomes mandatory using the if-converted method regardless of whether the effect of including the additional shares was dilutive or antidilutive. The Board reconsidered its conclusion on mandatorily convertible instruments and subsequently concluded, consistent with its reasoning about an instrument that is exercisable for little or no cost to the holder, that a mandatorily convertible instrument should be included in basic EPS only if the holder has the present right or is deemed to have the present right to share in current-period earnings with common shareholders.

B7. Statement 128 defines a participating security as a security "that may participate in dividends with common stocks according to a predetermined formula. . . ." Issue 03-6 further clarifies that a participating security is "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." Therefore, the Board concluded that if the mandatorily convertible instrument meets the definition of a participating security, the instrument should be included in basic EPS using the two-class method. The IASB agreed with the Board's decision and has proposed to amend IAS 33 to converge with the guidance in this proposed Statement for those instruments.

## Computation of Diluted EPS

### Instrument That May Be Settled in Cash or Shares

B8. 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 on which to believe that the contract would be paid partially or wholly in cash. Under IAS 33, all contracts are assumed to be settled in common shares if dilutive. The Board decided that the IASB's provisions would result in more consistent EPS calculations. Therefore, it decided to amend Statement 128 to converge with the IAS 33 requirement to assume share settlement, if dilutive.

B9. The Board believes that the objective of computing diluted EPS, as stated in paragraph 11 of Statement 128, is 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. 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 that 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 rejected this latter idea because it might encourage issuers to create contracts that include circumstances that permit or require share settlement to circumvent the intent of diluted EPS.

### Treasury Stock Method

### *Carrying Value of a Liability Included as Assumed Proceeds*

B10. The Board decided to include as assumed proceeds under the treasury stock method the end-of-period carrying value of an instrument that is classified as a liability, is not remeasured at fair value each period through earnings, and that would be extinguished upon exercise. The Board reasoned that if an instrument classified as a liability was 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 have that same effect on the issuer's net assets as would issuing shares in exchange for cash and that cash being used to pay off the obligation. The Board also observed, as a result of that change to the treasury stock method for instruments classified as a liability (and that are not measured at fair value), that there would be no effect on the diluted EPS calculation if equity instruments having a value equal to the end-of-period carrying value of the liability are used to settle the liability (for example, a fixed monetary obligation that may be settled in a variable number of shares).

B11. The Board noted that its decision to include liability extinguishment as an element of assumed proceeds under the treasury stock and reverse treasury stock methods 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 did not on the basis that such a change would be outside the scope of this short-term convergence project (treatment of convertible instruments in EPS is currently converged) and would be inconsistent with the current accounting for those instruments. 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 or reverse 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 after that project is completed.

### *End-of-Period Market Price*

B12. The Board also considered whether an entity should use the end-of-period market price instead of the average market price in computing the number of incremental shares under the treasury stock and reverse treasury stock methods. By using the end-of-period market price, the Board concluded it would:

a. Allow for consistency by including the end-of-period carrying value of a liability, if applicable, as an assumed proceed
b. Resolve an inconsistency in the existing standard in which, for purposes of computing the number of incremental shares, the exercise of options or warrants (or their equivalents) is assumed to occur at the beginning of the period while the repurchase of treasury shares is assumed to occur over the entire period.

The Board also believes that using the end-of-period market price would simplify the computation of diluted EPS.

### *Year-to-Date Computation*

B13. Statement 128 requires that the number of incremental shares to be included in the denominator of diluted EPS be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation. The Board decided to amend Statement 128 to converge with IAS 33 in calculating incremental shares included in the year-to-date diluted EPS computation to provide better comparability between U.S. GAAP and IFRS. That is, the number of incremental shares included in the year-to-date diluted EPS computation would be computed using the end-of-period market price (or the market price at time of exercise, if earlier) of common shares for the year-to-date period.

B14. Statement 128 requires that contingently issuable shares be determined for year-to-date periods on a weighted-average basis. That is, contingent shares are weighted for the interim periods in which they are included in the computation of diluted EPS. That treatment is inconsistent with the Board's conclusion on the year-to-date computation of instruments subject to the treasury stock method, which would eliminate the year-to-date weighted-average computation in applying that 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 during which the conditions for issuance are satisfied or the date of the contingent share arrangement, if later. Therefore, the Board decided to amend Statement 128's requirements for computing contingently issuable shares to be consistent with the amended requirements for the treasury stock method and IAS 33. Contingently issuable shares should be included in diluted EPS from the beginning of the quarterly and year-to-date periods, respectively, in which the conditions for issuance are satisfied (or from the date of the contingent share agreement, if later).

## Instruments That Are Measured at Fair Value Each Period with Changes in Fair Value Recognized in Earnings

B15. Given the changes to the treasury stock and reverse treasury stock methods (that is, including the end-of-period carrying value of a liability as assumed proceeds and using the end-of-period market price), the Board observed that in situations in which an instrument subject to those methods is measured at fair value each period on an entity's balance sheet, the inclusion of that amount as assumed proceeds of the treasury stock and reverse treasury stock methods will generally either have no effect on diluted EPS or be antidilutive. It was that observation that led the Board to the conclusion that an entity should not increase the denominator of the computation of diluted EPS for certain freestanding instruments (or a component of certain compound instruments that is accounted for as if it were freestanding) subject to the treasury stock and reverse treasury stock methods that are measured at fair value each period with changes in fair value recognized in earnings.

B16. The Board decided that an entity should not increase the denominator of the computation of diluted EPS for a share-based-payment award that is recognized (or will be recognized) as a liability and measured using Statement 123(R)'s fair-value-based method, even though the share-based-payment award is not measured at fair value (rather, it is measured at a fair-value-based amount) and (a) it may not be currently recognized as a liability or (b) compensation cost for the award may be capitalized as part of the cost of an asset and will be recognized in earnings in a future period. The Board reasoned that the changes in compensation cost recognized in earnings reflect the benefits received or detriments incurred by the current shareholders during the period similar to the instruments discussed in paragraphs B18 and B19. The Board also reasoned that the computation of diluted EPS would be simplified by not requiring an entity to track share-based-payment awards for which a portion of the award has not been recognized as a liability and it would be onerous to require an entity to track the timing of when compensation cost that has been capitalized would reduce earnings available to common shareholders in a future period.

B17. EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," specifies the measurement date for share-based-payment transactions with nonemployees. Issue 3 of Issue 96-18 states:

> The Task Force reached a consensus that when it is appropriate under generally accepted accounting principles for the issuer to recognize any cost of the transaction during financial reporting periods prior to the measurement date, for purposes of recognition of costs during those periods the equity instruments should be measured at their then-current fair values at each of those interim financial reporting dates. Changes in those fair values between those interim reporting dates should be attributed in accordance with the methods illustrated in Interpretation 28.

The Board considered whether a share-based-payment award issued to a nonemployee that is classified as equity and for which the measurement date has not occurred should be excluded from determining the denominator of the computation of diluted EPS. As discussed in paragraph B15, the Board decided that an instrument that is classified as a liability and is recognized at fair value each period should be excluded from determining the denominator of the computation of diluted EPS because the inclusion of the carrying amount of that liability as assumed proceeds and the use of the end-of-period market price in applying the treasury stock and reverse treasury stock methods would generally be antidilutive. Consistent with that decision, the Board decided that a share-based-payment award issued to a nonemployee for which the measurement date has not occurred should only be excluded from determining the denominator of the computation of diluted EPS if such instrument is classified as a liability. Because the carrying value of a share-based-payment award issued to a nonemployee that is classified as equity would not be included as assumed proceeds, such an award would not have the same effect on diluted EPS as a liability.

B18. Statement 128 states 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." Given the Board's decision about an instrument that is measured at fair value each period that would otherwise be subject to the treasury stock and reverse treasury stock methods, the Board considered whether the existing methods of computing EPS were the best methods of reporting the performance of an entity for other freestanding instruments (or a component of a compound instrument that is accounted for as if it were freestanding) that are measured at fair value each period with changes in fair value recognized in earnings (for example, convertible securities or participating securities).

B19. The Board believes that the performance of an entity for purposes of computing EPS should encompass the benefits received or the detriments incurred by the current shareholders during the period. The Board observed that the changes in fair value of those instruments reflect the economic effect of those instruments on current shareholders for the period. That is, the changes in fair value reflect the benefits received or detriments incurred by the current shareholders during the period, and those changes already have been included in the numerator of an EPS computation. Therefore, the Board decided that any freestanding instrument (or a component of a compound instrument that is accounted for as if it were freestanding), except for those share-based-payment awards discussed in paragraph B17, that is measured at fair value with changes in fair value recognized in earnings for the reporting period need not be included in determining the denominator of the computation of diluted EPS. As a result, the Board concluded that an entity should not apply the treasury stock, reverse treasury stock, if-converted, and two-class (both basic and diluted) methods for those instruments and that excluding those instruments from the denominator of diluted EPS or from the allocation of undistributed earnings under the two-class method would simplify the computation of diluted EPS.

B20. The Board acknowledged that the current methods of computing dilution focus on the potential for additional shares to become outstanding. The Board also acknowledged that there may be circumstances when an instrument that would have been dilutive under the previous methods would be excluded by this proposed Statement from the computation of the denominator of diluted EPS because the instrument is recognized (or will be recognized) at fair value with changes in fair value recognized in earnings (for example, a convertible debt instrument or an option for which its fair value is less than its intrinsic value). The Board reasoned that excluding those instruments from the denominator of diluted EPS represents a more realistic picture of the effect of those instruments on current shareholders because it does not assume one or more hypothetical transactions (for example, the treasury stock method assumes the exercise of all in-the-money options and the subsequent repurchase of shares from the proceeds of those exercises). The Board decided not to require incremental disclosures for those instruments beyond those already required by GAAP (for example, Statement 128, FASB Statement No. 129, *Disclosure of Information about Capital Structure,* and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"). The Board noted that current disclosure requirements in Statement 128 focus on instruments that do not dilute basic EPS in the current period but that could potentially dilute basic EPS in the future. The Board reasoned that the economic effect of those instruments on current shareholders for the period already has been reflected in the numerator of a diluted EPS computation in the current period and, therefore, additional disclosures would be inconsistent with the disclosure principle in Statement 128.

B21. The Board acknowledged that there may be (a) other objectives of diluted EPS that would be more useful to users, (b) other methods of computing diluted EPS that would be more useful to users, or (c) other possible simplifications of Statement 128 that could be implemented. However, the Board decided that considering those other objectives, methods, or simplifications are outside the scope of this short-term convergence project. Additionally, the Board reasoned that a fundamental review of EPS should not be undertaken before completion of the FASB and the IASB's joint projects on liabilities and equity and financial statement presentation.

### Two-Class Method

B22. In response to requests from constituents, the FASB added to its agenda a separate implementation project to provide computational guidance for diluted EPS when applying the two-class method. Those constituents noted that the existing accounting literature provides clear examples of the application of the two-class method in computing basic EPS but does not specifically address or illustrate the application of the two-class method in computing diluted EPS. The goal of the separate project was to clarify the application of the two-class method to the computation of diluted EPS and to provide illustrations for a variety of scenarios. Respondents to the proposed FASB Staff Position (FSP) FAS 128-a, *Computational Guidance for Computing Diluted EPS under the Two-Class Method,* generally favored the proposed FSP, though they commented that either it should be incorporated into this proposed Statement or that the Board should align the effective date of the proposed FSP with that of this proposed Statement. Based on the respondents' comments and to reduce the number of pronouncements related to EPS, the Board decided to incorporate the guidance in that proposed FSP into this proposed Statement.

B23. The Board decided that income from continuing operations (or net income) should not be reduced by additional dividends that would be assumed to be declared for potential common shares or potential participating securities that are assumed to be outstanding. In reaching this conclusion, the Board reasoned that an entity may make a different decision on the per-share amount of dividends declared if such a per-share amount was distributed to all potential common shares. The IASB agreed with the Board's decisions about the computation of diluted EPS under the two-class method and has proposed to amend IAS 33 to converge with the guidance in this proposed Statement.

## Convergence of U.S. GAAP and IFRS

B24. This proposed 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 the development of a single set of high-quality accounting standards. The Board believes the amendments of this proposed Statement would eliminate known differences between Statement 128 and IAS 33. The Board believes that it has achieved its stated objective of convergence by providing amendments in this proposed Statement that would result in the same EPS denominator of diluted EPS as would result from IAS 33, as proposed to be amended, except when differences in the underlying accounting for certain instruments exist under U.S. GAAP and IFRS. The Board acknowledges that there will be instruments that, due to differences in the underlying accounting, will not result in the same EPS denominator under U.S. GAAP and IFRS. Those instruments include, but are not limited to, forward purchase contracts that provide for the option of gross physical or net-share or net-cash settlement, written put options, and convertible debt instruments that may be settled in cash upon conversion. The Boards' shared goal is to eliminate differences in the accounting for those instruments through the active project on liabilities and equity.

B25. The Board also acknowledged that a number of differences in accounting result in different numerators (that is, income from continuing operations or net income) under U.S. GAAP and IFRS. The Board noted that addressing the underlying reasons for those differences is outside the scope of this short-term convergence project. Finally, the Board acknowledged that in some areas, the existing application guidance in Statement 128 and other interpretative guidance goes beyond the level of detail provided in IAS 33. The FASB and the IASB, however, agreed in these instances that the extra level of detail in Statement 128 and other interpretive guidance was consistent with at least one acceptable conclusion under IAS 33 and, therefore, would not create a convergence difference.

## Effective Date and Transition

B26. The Board agreed that this proposed Statement should be effective as of the beginning of a fiscal year and that early application would be prohibited. The Board considered but decided not to include a specific effective date for a final Statement in this proposed Statement, noting the difficulties of determining a likely effective date before understanding the nature of respondents' comments and the time it will take to consider them. Additionally, the Board agreed that not specifying an effective date will give the Board the opportunity to consider its deliberations on the liabilities and equity project and the convergence timeline in establishing a final effective date. Accordingly, consistent with the IASB's practice, the Board decided to determine the effective date when it approves the final amendments to Statement 128.

B27. 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. They pointed out that retrospective application 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 retrospective application for those contracts that on or before the last day of the period of adoption were settled in cash or were modified such that the instruments can no longer be settled in shares. The Board decided that *that* exception to the transition requirements of this proposed Statement is a reasonable accommodation to preparers and will not compromise the quality of financial information provided to users.

## Benefit-Cost Considerations

B28. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Current and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement a new standard are borne primarily by current investors. The Board's assessment of the costs and benefits of issuing an accounting standard is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement an accounting standard or to quantify the value of improved information in financial statements. The Board's assessment of this proposed Statement's benefits and costs is based on discussions with preparers, auditors, regulators, and users of financial statements. The Board considered the incremental costs of implementing the provisions of this proposed Statement and concluded that those costs do not outweigh the benefits of comparability and simplification.

### Benefits

B29. The FASB and the IASB made a commitment to converge the accounting standards of their respective jurisdictions through a long-term convergence plan. The FASB and the IASB believe that developing a common set of high-quality financial accounting standards improves the comparability of financial information around the world and simplifies the accounting for entities that issue financial statements in accordance with U.S. GAAP or IFRS. Therefore, the Board believes that a benefit of this proposed Statement for users would be that the comparability of EPS between entities that issue financial statements in accordance with U.S. GAAP or IFRS would be improved in that instruments issued by these entities would be reflected in EPS in a similar manner, except when differences in the underlying accounting for certain instruments exist under U.S. GAAP and IFRS. The Board also believes that a benefit of this proposed Statement for preparers would be that the computation of diluted EPS would be simplified by (a) using the end-of-period market price in calculating the incremental number of shares and (b) eliminating the need to include instruments that are measured at fair value each period with changes in fair value recognized in earnings in the denominator of the computation of diluted EPS.

### Costs

B30. Because the Board believes that this proposed Statement would be simplifying the computation of EPS, the Board does not expect that the cost of implementing the provisions of this proposed Statement would be significant. Additionally, the Board believes that the cost of implementing the provisions of this proposed Statement would primarily occur upon adoption through modifications to an entity's accounting systems and, therefore, would not be burdensome on an ongoing basis.

## Alternative Views

B31. Two Board members believe the Board should not issue this proposed Statement and should not proceed with this project.

B32. The stated objective of this proposed Statement is to improve the comparability of EPS computations between IFRS and GAAP in the United States by simplifying and converging the requirements for calculating the EPS denominator. Those Board members believe this proposed Statement would not noticeably improve comparability—despite the same or similar denominators—because the EPS computations under U.S. GAAP and IFRS will continue to be different as long as there are differences in the way net income (profit and loss) is determined. Accordingly, convergence in the methodology used to determine the number of shares to be used in computing EPS will not significantly improve comparability. Additionally, the objective of the short-term convergence project (that is, achieving convergence by arriving at the same EPS denominator under both U.S.

GAAP and IFRS) is not achieved because of the differences in the underlying accounting for certain instruments.

B33. In addition, those Board members believe that the proposals in this proposed Statement would not significantly simplify the computation of EPS by issuers of financial statements. In many cases (except as described in paragraph B34), the proposed exclusion of certain options, warrants, and their equivalents from the denominator of diluted EPS (those that are measured at fair value each period with changes in fair value recognized in earnings) would produce the same results as the treasury stock and reverse treasury stock methods (as proposed to be amended by this proposed Statement), but it would not eliminate those other methods for these instruments. That is, the same level of convergence could be achieved for these instruments by applying the treasury stock and reverse treasury stock methods (as proposed to be amended by this proposed Statement). The treasury stock and reverse treasury stock methods (as proposed to be amended by this proposed Statement) would still be required for instruments not reported at fair value.

B34. Finally, those Board members believe that the exclusion from the denominator of diluted EPS convertible securities that are measured at fair value each period with changes in fair value recognized in earnings produces results that are not consistent with the needs of users trying to assess potential dilution possibilities. At best, excluding these securities produces an EPS that reflects the effects of changes in fair value of the instruments on the current period's earnings. However, the primary reason many users are interested in diluted EPS is to assess possible future dilution, which would be better represented using the if-converted method. Excluding these instruments from the denominator of diluted EPS would actually result in diluted EPS being greater than diluted EPS computed using the if-converted method in a period in which a convertible security's fair value declined. That could be particularly misleading if the security's conversion price is still below the price of the securities to be received if it was converted. This proposed Statement would place much more of a burden on users trying to understand the full potential future effect of dilutive instruments. Those Board members believe that preparers need to provide disclosures of diluted EPS under the if-converted method to meet the needs of users. This would negate any preparer benefit from excluding these instruments from the denominator of diluted EPS.

B35. Instead of continuing to work on the proposals in this proposed Statement, those Board members believe the Board should wait until the projects on financial statement presentation and liabilities and equity are completed and then undertake a project to comprehensively reconsider EPS. The introduction of a new methodology, such as the exclusion of certain instruments from the denominator of diluted EPS, is beyond the scope of a limited convergence project and should be considered as part of a broader scale reconsideration of performance reporting.

## Appendix C

## AMENDMENTS TO OTHER AUTHORITATIVE LITERATURE

C1. This appendix addresses the effect of this Statement on 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.

C2. This Statement nullifies the following Emerging Issues Task Force (EITF) D-Topics:

a. Topic No. D-62, "Computing Year-to-Date Diluted Earnings per Share under FASB Statement No. 128"

b. Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share"

C3. EITF Issue No. 85-18, "Earnings-per-Share Effect of Equity Commitment Notes," is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

**[For ease of use, only the portions of this Issue affected by this Statement have been reproduced.]**

**EITF DISCUSSION**

The Task Force reached a consensus that shares contingently issuable under equity commitment notes and equity contract notes should not be included in either primary or fully diluted earnings-per-share computations. The Task Force agreed that no substantive differences between equity commitment notes and equity contract notes would appear to affect that consensus. [Note: This consensus has been nullified by Statement 128, as amended by Statement 16X. See STATUS section.]

The SEC Observer indicated, and the Task Force agreed, that supplemental earnings-per-share disclosure was appropriate in certain circumstances and that related shares should be determined based on the market price of common stock for each reporting period. [Note: See STATUS section.]

**STATUS**

Statement 128, as amended by Statement 16X, nullifies the first consensus in Issue 85-18 by stating 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, if dilutive ~~unless past experience or a stated policy provides a reasonable basis to believe otherwise~~. Statement 128 supports the second consensus reached; equity contracts that require payment in stock should be considered potentially dilutive securities (convertible debt).

Statement 16X, issued in XXX 2009, amends Statement 128 to (1) assume as proceeds the end-of-period carrying value of a liability that is assumed to be share settled and is not remeasured at fair value each period through earnings and (2) require the use of the end-of-period market price in computing incremental shares under the treasury stock method.

C4. EITF Issue No. 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested," is amended as follows:

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**EITF DISCUSSION**

The Task Force also reached a consensus that employer shares held by the rabbi trust should 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 should be reflected in the denominator of the basic EPS computation in accordance with the provisions of Statement 128. In accordance with paragraphs 9A and 10 of Statement 128, as amended by Statement 16X, if an obligation is required to be settled by delivery of shares of employer stock (Plan A), those shares should be included in the calculation of (1) basic EPS if (a) the shares are currently issuable for little or no cost to the holder or (b) the shares meet the definition of a participating security that is not measured at fair value each period with changes in fair value recognized in earnings and (2) 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 would not be reflected in basic EPS but would be included in the calculation of diluted EPS in accordance with paragraphs 22, ~~and~~ 29, and 29A of Statement 128, as amended by Statement 16X. [Note: See STATUS section.]

**STATUS**

**[Note: The following paragraphs are added before the last paragraph of the STATUS section:]**

Statement 16X, issued in XXX 2009, amends Statement 128 to clarify that the computation of basic EPS should include common shares outstanding and instruments for which the holder has (or is deemed to have) the present right as of the end of the period to share in current-period earnings. Examples of those instruments include (1) an instrument that is currently exercisable for little or no cost to the holder, (2) shares that are currently issuable for little or no cost to the holder, (3) a participating security that is not measured at fair value each period with changes in fair value recognized in current-period earnings, or (4) a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

Statement 16X amends Statement 128 to eliminate an entity's ability to rebut the presumption that an instrument that can be settled in cash or shares will be settled in shares. Share settlement must be assumed for an otherwise cash-settled instrument that contains a provision that requires or permits share settlement under any circumstance, unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer.

C5. EITF Issue No. 99-7, "Accounting for an Accelerated Share Repurchase Program," is amended as follows:

a. Paragraph 5:

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 Statement 128, as amended by Statement 16X.~~, as interpreted by Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share."~~ [Note: See paragraphs 10 and 11 of the STATUS section.]

b. Paragraph 10:

~~No further EITF discussion is planned.~~Statement 16X, issued in XXX 2009, nullifies Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share," and amends Statement 128 to eliminate an entity's ability to rebut the presumption that an instrument that can be settled in cash or shares will be settled in shares. Share settlement must be assumed for an otherwise cash-settled instrument that contains a provision that requires or permits share settlement under any circumstance, unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer.

c. Paragraphs 11 and 12 are added as follows:

11. Statement 16X amends Statement 128 to (a) assume as proceeds the end-of-period carrying value of a liability that is assumed to be share settled and is not remeasured at fair value each period through earnings and (b) require the use of the end-of-period market price in computing incremental shares under the treasury stock method.

12. No further EITF discussion is planned.

C6. EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," is amended as follows:

a. Paragraph 48:

In accordance with Statement 128, as amended by Statement 16X, an entity shall not increase the denominator of diluted earnings per share (EPS) for additional shares that would arise from the exercise or conversion of freestanding instruments (or a component of a compound instrument that is accounted for as if it were freestanding) that are measured at fair value each period with changes in fair value recognized in earnings. All other contracts that require the reporting entity to repurchase its own stock and are “in the money” at the end of the reporting period shall be reflected in the computation of diluted EPS using the reverse treasury stock method if the effect is dilutive.~~In computing diluted earnings per share (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.~~ [Note: See paragraph 75 of the STATUS section.] Under that method, the incremental number of shares is computed as (a) the number of shares that would need to be issued for cash at the ~~average~~end-of-period market price during the period to obtain cash to satisfy the put obligation less (b) the number of shares received from satisfying the put. Statement 128 states that purchased options should not be reflected in the computation of diluted EPS because to do so would be antidilutive. [Note: See paragraph 81 of the STATUS section.]

b. Paragraph 49:

At the July 23 and November 18–19, 1998 meetings, an FASB staff representative made an announcement (Topic No. D-72, “Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share”) 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. 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. 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. [Note: See paragraph 82 of the STATUS section.]

c. Paragraph 81:

~~No further EITF discussion is planned.~~Statement 16X, issued in XXX 2009, amends Statement 128 such that an entity should not increase the denominator of diluted EPS for additional common shares that would arise from the exercise or conversion of a freestanding instrument (or a component of a compound instrument that is accounted for as if it were freestanding) that is measured at fair value with changes in fair value recognized in earnings each reporting period. Statement 16X also amends Statement 128 to (a) assume as proceeds the end-of-period carrying value of a liability that is assumed to be share settled and is not remeasured at fair value each period through earnings and (b) require the use of the end-of-period market price in computing incremental shares under the treasury stock and reverse treasury stock methods.

d. Paragraphs 82 and 83 are added as follows:

82. Statement 16X nullifies Topic D-72 and amends Statement 128 to eliminate an entity’s ability to rebut the presumption that an instrument that can be settled in cash or shares will be settled in shares. Share settlement must be assumed for an otherwise

cash-settled instrument that contains a provision that requires or permits share settlement under any circumstance, unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer.

83. No further EITF discussion is planned.

C7. EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," is amended as follows:

a. The following Note is added to the end of paragraphs 14–17, 19, and 22:

[Note: See paragraph 26 of the STATUS section.]

b. Paragraph 20:

The Task Force decided to discontinue its discussion on Issue 6 noting that convertible participating securities should be included in the computation of diluted EPS using the if-converted method, subject to the antidilution provisions of Statement 128. [Note: See paragraph 27 of the STATUS section.]

c. Paragraph 21:

**[For ease of use, only the portion of this paragraph affected by this Statement has been reproduced.]**

The Task Force reached a consensus on Issue 7 that convertible participating securities should be included in the computation of basic earnings per share using the two-class method. This consensus nullifies the guidance previously included in Topic D-95. The following examples illustrate the application of the two-class method of computing basic earnings per share for (a) an entity that has participating convertible preferred stock and (b) an entity that has participating convertible bonds: [Note: This consensus has been codified into Statement 128. See paragraphs 26 and 28 of the STATUS section.]

d. Paragraph 26:

~~No further EITF discussion is planned.~~Statement 16X, issued in XXX 2009, is effective for financial statements issued for fiscal years beginning after [date to be inserted after exposure], and interim periods within those fiscal years. Pursuant to Statement 16X, which amends Statement 128, a participating security that is measured at fair value each period with changes in fair value recognized in earnings would not be included in the computation of basic and diluted EPS using the two-class method. Similarly, a participating share-based-payment award that is recognized as a liability and measured at a fair-value-based amount under Statement 123(R) is not included in the computation of basic and diluted EPS using the two-class method.

e. Paragraphs 27–29 are added as follows:

27. Statement 16X amends Statement 128 to provide guidance on the computation of diluted EPS using the two-class method. Statement 16X states that when a participating security also is a potential common share, diluted EPS should reflect the more dilutive of (a) applying the two-class method or (b) the application of the treasury stock method, reverse treasury stock method, if-converted method, or contingently issuable share method for the participating security.

28. Statement 16X codifies into Statement 128 the consensus reached by the Task Force on Issue 7, which requires that convertible participating securities be included in the computation of basic EPS using the two-class method.

29. No further EITF discussion is planned.

C8. EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," is amended as follows:

a. Paragraph 4:

The Task Force reached a consensus that contingently convertible instruments should be included in diluted earnings per share (if dilutive) regardless of whether the market price trigger has been met. The Task Force observed that there is no substantive economic difference between contingently convertible instruments and conventional convertible instruments with a market price conversion premium. Accordingly, the Task Force concluded that the treatment for diluted EPS should not differ because of a contingent market price trigger. [Note: See paragraph 15 of STATUS section.]

b. Paragraph 15:

~~No further EITF discussion is planned.~~Statement 16X, issued in XXX 2009, amends Statement 128 such that an entity should not increase the denominator of diluted EPS for additional common shares that would arise from the exercise or conversion of a freestanding instrument (or a component of a compound instrument that is accounted for as if it were freestanding) that is measured at fair value each period with changes in fair value recognized in earnings. As a result, a contingently convertible instrument that is measured at fair value each period with changes in fair value recognized in earnings would not be included in the denominator of the computation of diluted EPS.

c. Paragraphs 16 and 17 are added as follows:

16. Statement 16X amends Statement 128 to (a) assume as proceeds the end-of-period carrying value of a liability that is assumed to be share settled and that is not remeasured at fair value each period through earnings and (b) require the use of the end-of-period market price in computing incremental shares under the treasury stock and reverse treasury stock methods. Statement 16X also nullifies Topic No. D-72 "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share," and amends Statement 128 to eliminate an entity's ability to rebut the presumption that an instrument that can be settled in cash or shares

will be settled in shares. Share settlement must be assumed for an otherwise cash-settled instrument that contains a provision that requires or permits share settlement under any circumstance, unless the only circumstance that would permit or require share settlement is the legal bankruptcy of the issuer.

17. No further EITF discussion is planned.

d. Exhibit 04-8A, and its related footnotes 4a and 5, as amended:

**[For ease of use, only the portions of this example affected by this Statement have been reproduced.]**

**Example 2—Contingently convertible debt with a market price trigger that requires settlement of the principal amount of the debt in cash upon conversion**

In Example 2, the assumptions are the same as Example 1 except that the issuer of the contingently convertible debt must settle the principal amount of the debt in cash upon conversion and it may settle the 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~~end-of-period share price for the year is $64. [Note: See paragraph 16 of STATUS section.]

The if-converted method should not be used to determine the earnings-per-share implications of convertible debt with the characteristics described in this example. 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 29 and 29A of Statement 128, as amended by Statement 16X. ~~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."~~ The convertible debt instrument in this example is subject to other applicable guidance in Statement 128, as amended by Statement 16X, as well, including the antidilution provisions of that Statement. [Note: See paragraph 16 of STATUS section.]

In this example, basic EPS is $4.99,[4a] and diluted earnings per share is $4.98.[5]

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[4a]Basic EPS = IACS ÷ SO = $9,980 ÷ 2,000 shares = $4.99 per share.

[5]Potential common shares = (Conversion spread value) ÷ (~~Average~~End-of-period share price) = $14 × 20 shares ÷ $64 = 4.38 shares.

Diluted EPS = IACS ÷ (SO + Potential common shares) = ($9,980) ÷ (2,000 + 4.38) shares = $4.98 per share.

C9. AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans,* is amended as follows:

a. Paragraph 32:

When participants withdraw account balances containing convertible preferred shares from an ESOP, 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 should 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 should be included in the denominator of the EPS calculation, should be ~~the greater of (*a*) the shares issuable at the stated conversion rate and (*b*)~~ the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed based on the ratio of (*a*) the average fair value of the convertible stock or, if greater, its stated minimum value, to (*b*) the average fair value of the common stock. [Revised, ~~November 1998~~XXXX 2009, to reflect conforming changes necessary due to the issuance of FASB Statement No. ~~128~~16X.]

C10. AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities,* is amended as follows:

a. Exhibit 4-4 of Chapter 4:

**[For ease of use, only the portion of this exhibit affected by this Statement has been reproduced.]**

†FASB Statement No. 128, *Earnings per Share*, as amended by FASB Statement No. 16X, *Earnings per Share*, requires presentation of earnings per share 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. FASB Statement No. 128, as amended by FASB Statement No. 16X, also requires presentation of earnings per share 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.

~~In December 2003, FASB issued an exposure draft of a proposed statement entitled *Earnings per Share—an amendment of FASB Statement No. 128*. This proposed Statement would amend the computational guidance in FASB Statement No. 128,~~

~~*Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the treasury stock method. Also, this proposed Statement would eliminate the provisions of Statement 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. As the result of its redeliberations of the 2003 Exposure Draft, the FASB made additional changes to the requirements of FASB Statement No. 128 but has not made significant changes to the other issues addressed in that Exposure Draft. Therefore, a revised Exposure Draft that addresses the additional changes to the requirements of FASB Statement No. 128 was issued on September 30, 2005. The comment period ended on November 30, 2005.~~