Statement of Financial Accounting Standards No. 128

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Earnings per Share

February 1997

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 128 Summary

This Statement establishes standards for computing and presenting earnings per share (EPS) and applies to entities with publicly held common stock or potential common stock. This Statement simplifies the standards for computing earnings per share previously found in APB Opinion No. 15, *Earnings per Share,* and makes them comparable to international EPS standards. It replaces the presentation of primary EPS with a presentation of basic EPS. It also requires dual presentation of basic and diluted EPS on the face of the income statement for all entities with complex capital structures and requires a reconciliation of the numerator and denominator of the basic EPS computation to the numerator and denominator of the diluted EPS computation.

Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Diluted EPS is computed similarly to fully diluted EPS pursuant to Opinion 15.

This Statement supersedes Opinion 15 and AICPA Accounting Interpretations 1-102 of Opinion 15. It also supersedes or amends other accounting pronouncements listed in Appendix D. The provisions in this Statement are substantially the same as those in International Accounting Standard 33, *Earnings per Share,* recently issued by the International Accounting Standards Committee.

This Statement is effective for financial statements issued for periods ending after December 15, 1997, including interim periods; earlier application is not permitted. This Statement requires restatement of all prior-period EPS data presented.

INTRODUCTION

1. This Statement specifies the computation, presentation, and disclosure requirements for **earnings per share** [1] (EPS) for entities with publicly held **common stock** or **potential common stock**. This Statement's objective is to simplify the computation of earnings per share

and to make the U.S. standard for computing earnings per share more compatible with the EPS standards of other countries and with that of the International Accounting Standards Committee (IASC).

2. In 1969, the AICPA issued APB Opinion No. 15, *Earnings per Share,* and by 1971 had published 102 Accounting Interpretations of Opinion 15. Given the widespread use of EPS data, the objective of Opinion 15 was to provide a standard so that earnings per share would be computed on a consistent basis and presented in the most meaningful manner. That objective also underlies this Statement.

3. Opinion 15 permitted a single presentation of "earnings per common share" for entities with simple capital structures. That presentation was similar to **basic EPS,** which is a common presentation outside the United States. However, Opinion 15 required that entities with complex capital structures present both "primary" and "fully diluted" EPS on the face of the income statement. The primary EPS computation included "common stock equivalents" in the denominator (the number of common shares outstanding). Only two other countries require presentation of primary EPS; all other countries that have EPS requirements require presentation of only basic EPS or both basic and fully diluted EPS.

4. In October 1993, the IASC issued a draft Statement of Principles, *Earnings per Share,* for public comment. Because earnings per share is one of the most widely used financial statistics, the IASC's goal was to initiate a common approach to the determination and presentation of earnings per share that would permit global comparisons. Even though EPS data may have limitations because of the different national methods for determining "earnings," the IASC and the FASB believe that a consistently determined denominator will be a significant improvement in international financial reporting.

5. The Board pursued its EPS project concurrently with the IASC to help achieve international harmonization of the accounting standards for computing earnings per share. The focus of the project was on the denominator of the EPS computation, not on issues about the determination of earnings. The IASC issued IAS 33, *Earnings per Share*, concurrently with the issuance of this Statement; the provisions in that Standard are substantially the same as those in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

6. This Statement 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. This Statement 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. This Statement does not require presentation of earnings per share for investment companies [2] or in statements of wholly owned subsidiaries. Any entity that is not required by this Statement to present earnings per share in its financial statements that chooses to present earnings per share in its financial statements shall do so in accordance with the provisions of this Statement.

7. This Statement supersedes Opinion 15, AICPA Accounting Interpretations 1-102 of Opinion 15, AICPA Accounting Interpretations 1, "Changing EPS Denominator for Retroactive Adjustment to Prior Period," and 2, "EPS for 'Catch-up' Adjustment," of APB Opinion No. 20, *Accounting Changes,* FASB Statement No. 85, *Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent,* and FASB Interpretation No. 31, *Treatment of Stock Compensation Plans in EPS Computations.* It also amends other accounting pronouncements listed in Appendix D.

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.

10. Shares issuable for little or no cash consideration upon the satisfaction of certain conditions (**contingently issuable shares**) shall be considered outstanding common shares and included in the computation of basic EPS as of the date that all necessary conditions have been satisfied (in essence, when issuance of the shares is no longer contingent). Outstanding common shares that are contingently returnable (that is, subject to recall) shall be treated in the same manner as contingently issuable shares. [5]

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.

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, an extraordinary item, or the cumulative effect of an accounting change 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]

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, and partially paid stock subscriptions. [9] Under the treasury stock method:

a. Exercise of options and warrants shall be assumed at the beginning of the period (or at time of issuance, if later) and common shares shall be assumed to be issued.
b. The proceeds from exercise shall be assumed to be used to purchase common stock at the average market price during the period. [10]
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. [11]

18. Options and warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options or warrants (they are "in the money"). Previously reported EPS data shall not be retroactively adjusted as a result of changes in market prices of common stock.

19. Dilutive options or warrants that are issued during a period or that expire or are canceled during a period shall be included in the denominator of diluted EPS for the period that they were outstanding. Likewise, dilutive options or warrants exercised during the period shall be included in the denominator for the period prior to actual exercise. The common shares issued upon exercise of options or warrants shall be included in the denominator for the period after the exercise date. Consequently, incremental shares assumed issued shall be weighted for the period the options or warrants were outstanding, and common shares actually issued shall be weighted

for the period the shares were outstanding.

Stock-Based Compensation Arrangements

20. Fixed awards and nonvested stock (as defined in FASB Statement No. 123, *Accounting for Stock-Based Compensation*) to be issued to an employee [12] under a stock-based compensation arrangement are considered options for purposes of computing diluted EPS. Such stock-based awards shall be considered to be outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent upon vesting. Those stock-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 stock-based compensation arrangements shall be computed using the treasury stock method. If the stock-based awards were granted during the period, the shares issuable must be weighted to reflect the portion of the period during which the awards 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 amount of compensation cost attributed to future services and not yet recognized, [13] and (c) the amount of tax benefits (both deferred and current), if any, that would be credited to additional paid-in capital assuming exercise of the options. Assumed proceeds shall not include compensation ascribed to past services. The 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 17 of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* states that in some instances the tax deduction for compensation may be less than the compensation expense recognized for financial reporting purposes. If the resulting difference in income tax will be deducted from capital in accordance with that paragraph, such taxes to be deducted from capital shall be treated as a reduction of assumed proceeds.

22. If stock-based compensation arrangements are payable in common stock or in cash at the election of either the entity or the employee, the determination of whether such stock-based awards are potential common shares shall be made based on the provisions in paragraph 29. If an entity has a tandem plan (as defined in Statement 123) that allows the entity or the employee to make an election involving two or more types of equity instruments, diluted EPS for the period shall be computed based on the terms used in the computation of compensation expense for that period.

23. Performance awards (as defined in Statement 123) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 30-35 of this Statement. As discussed in paragraph 26 of Statement 123, targeted stock price options are not considered to be a

performance award. However, because options with a target stock price have a market price contingency, the contingent share provisions of this Statement shall be applied in determining whether those options are included in the computation of diluted EPS.

Written Put Options

24. Contracts that require that the reporting entity repurchase its own stock, such as written **put options** and forward purchase contracts, shall be reflected in the computation of diluted EPS if the effect is dilutive. If those contracts are "in the money" during the reporting period (the exercise price is above the average market price for that period), the potential dilutive effect on EPS shall be computed using the **reverse treasury stock method.** Under that method:

a. Issuance of sufficient common shares shall be assumed at the beginning of the period (at the average market price during the period) to raise enough proceeds to satisfy the contract.
b. The proceeds from issuance shall be assumed to be used to satisfy the contract (that is, to buy back shares).
c. The incremental shares (the difference between the number of shares assumed issued and the number of shares received from satisfying the contract) shall be included in the denominator of the diluted EPS computation. [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 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 convertible securities that are issued during a period in circumstances where conversion options lapse, preferred stock is redeemed, or related debt is extinguished 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 that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Statement) if the effect is more dilutive. A contract that is reported as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument for accounting purposes during the period. That adjustment is similar to the adjustments required for convertible debt in paragraph 26(b). The presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

Contingently Issuable Shares

30. Shares whose issuance is contingent upon the satisfaction of certain conditions shall be considered outstanding and included in the computation of diluted EPS as follows:

a. If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares shall be included as of the beginning of the period in which the conditions were satisfied (or as of the date of the contingent stock agreement, if later).
b. If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS shall be based on the number of shares,

if any, that would be issuable if the end of the reporting period were the end of the contingency period (for example, the number of shares that would be issuable based on current period earnings or period-end market price) and if the result would be dilutive. Those contingently issuable shares shall be included in the denominator of diluted EPS as of the beginning of the period (or as of the date of the contingent stock agreement, if later). [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.

Presentation on Face of Income Statement

36. Entities with simple capital structures, that is, those with only common stock outstanding, shall present basic per-share amounts for income from continuing operations [20] and for net income on the face of the income statement. All other entities shall present basic and diluted per-share amounts for income from continuing operations and for net income on the face of the income statement with equal prominence.

37. An entity that reports a discontinued operation, an extraordinary item, or the cumulative effect of an accounting change in a period shall present basic and diluted per-share amounts for those line items either on the face of the income statement or in the notes to the financial statements. Per-share amounts not required to be presented by this Statement that an entity chooses to disclose shall be computed in accordance with this Statement and disclosed only in the notes to the financial statements; it shall be noted whether the per-share amounts are pretax or net of tax. [21]

Periods Presented

38. Earnings per share data shall be presented for all periods for which an income statement or summary of earnings is presented. If diluted EPS data are reported for at least one period, they shall be reported for all periods presented, even if they are the same amounts as basic EPS. If basic and diluted EPS are the same amount, dual presentation can be accomplished in one line on the income statement.

Terminology

39. The terms *basic EPS* and *diluted EPS* are used in this Statement to identify EPS data to be presented and are not required to be captions used in the income statement. There are no explicit requirements for the terms to be used in the presentation of basic and diluted EPS; terms such as *earnings per common share* and *earnings per common share—assuming dilution,* respectively, are appropriate.

Disclosure Requirements

40. For each period for which an income statement is presented, an entity shall disclose the following:

a. A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations. [22] The reconciliation shall include the individual income and share amount effects of all securities that affect earnings per share. [23] Illustration 2 in Appendix C provides an example of that disclosure.
b. The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
c. Securities (including those issuable pursuant to contingent stock agreements) that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented.

41. For the latest period for which an income statement is presented, an entity shall provide a description of any transaction that occurs after the end of the most recent period but before issuance of the financial statements that would have changed materially the number of common shares or potential common shares outstanding at the end of the period if the transaction had occurred before the end of the period. Examples of those transactions include the issuance or acquisition of common shares; the issuance of warrants, options, or convertible securities; the resolution of a contingency pursuant to a contingent stock agreement; and the conversion or exercise of potential common shares outstanding at the end of the period into common shares.

Computational Guidance

42. The determination of EPS data as required by this Statement considers the complexities of the capital structures of some entities. The calculations also shall give effect to matters such as stock dividends or splits and business combinations. Guidelines for dealing with some common computational matters and some complex capital structures are set forth in Appendix A. That appendix is an integral part of the requirements of this Statement.

Effective Date and Transition

43. This Statement shall be effective for financial statements for both interim and annual periods ending after December 15, 1997. Earlier application is not permitted. However, an entity is permitted to disclose pro forma EPS amounts computed using this Statement in the notes to the financial statements in periods prior to required adoption. After the effective date, all prior-period EPS data presented shall be restated (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of this Statement.

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

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
Gaylen N. Larson
James J. Leisenring
Gerhard G. Mueller

Appendix A

COMPUTATIONAL GUIDANCE

CONTENTS

Paragraph Numbers

Appendix A: COMPUTATIONAL GUIDANCE

Introduction

44. This appendix, which is an integral part of the requirements of this Statement, provides general guidance to be used in the computation of earnings per share.

Computing a Weighted Average

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

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. 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 to purchase convertible securities shall be assumed to be exercised to purchase the convertible security whenever the average prices of both the convertible security and the common stock obtainable upon conversion are above the exercise price of the options or warrants. However, exercise shall not be assumed unless conversion of similar outstanding convertible securities, if any, also is assumed. The treasury stock method shall be applied to determine the incremental number of convertible securities that are assumed to be issued and immediately converted into common stock. Interest or dividends shall not be imputed for the incremental convertible securities because any imputed amount would be reversed by the if-converted adjustments for assumed conversions.

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 the effect is dilutive. Those potential common shares will have a dilutive effect if (a) the average market price of the related common stock for the period exceeds the exercise price or (b) the security to be tendered is selling at a price below that at which it may be tendered under the option or warrant agreement and the resulting discount is sufficient to establish an effective exercise price below the market price of the common stock obtainable upon exercise. 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 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.

Restatement of EPS Data

Stock Dividends or Stock Splits

54. If the number of common shares outstanding increases as a result of a stock dividend or stock split [24] or decreases as a result of a reverse stock split, the computations of basic and diluted EPS shall be adjusted retroactively for all periods presented to reflect that change in capital structure. If changes in common stock resulting from stock dividends, stock splits, or reverse stock splits occur after the close of the period but before issuance of the financial statements, the per-share computations for those and any prior-period financial statements presented shall be based on the new number of shares. If per-share computations reflect such changes in the number of shares, that fact shall be disclosed.

Rights Issues

55. A **rights issue** whose exercise price at issuance is less than the fair value of the stock contains a bonus element that is somewhat similar to a stock dividend. If a rights issue contains a bonus element and the rights issue is offered to all existing stockholders, basic and diluted EPS shall be adjusted retroactively for the bonus element for all periods presented. If the ability to exercise the rights issue is contingent on some event other than the passage of time, the provisions of this paragraph shall not be applicable until that contingency is resolved.

56. The number of common shares used in computing basic and diluted EPS for all periods prior to the rights issue shall be the number of common shares outstanding immediately prior to the issue multiplied by the following factor: (fair value per share immediately prior to the exercise of the rights)/(theoretical ex-rights fair value per share). Theoretical ex-rights fair value per share shall be computed by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds expected from the exercise of the rights and dividing by the number of shares outstanding after the exercise of the rights. Illustration 5 in Appendix C

provides an example of that provision. If the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this computation shall be established at the close of the last day on which the shares are traded together with the rights.

Prior-Period Adjustments

57. Certain APB Opinions and FASB Statements require that a restatement of the results of operations of a prior period be included in the income statement or summary of earnings. In those instances, EPS data given for the prior period or periods shall be restated. The effect of the restatement, expressed in per-share terms, shall be disclosed in the period of restatement.

58. Restated EPS data shall be computed as if the restated income or loss had been reported originally in the prior period or periods. Thus, it is possible that common stock assumed to be issued upon exercise, conversion, or issuance of potential common shares in accordance with the provisions of this Statement may not be included in the computation of restated EPS amounts. That is, retroactive restatement of income from continuing operations could cause potential common shares originally determined to be dilutive to become antidilutive pursuant to the control number provision in paragraph 15. The reverse also is true. Retroactive restatement also may cause the numerator of the EPS computation to change by an amount that differs from the amount of the retroactive adjustment.

Business Combinations and Reorganizations

59. When common shares are issued to acquire a business in a transaction accounted for as a purchase business combination, the computations of earnings per share shall recognize the existence of the new shares only from the acquisition date. When a business combination is accounted for as a pooling of interests, EPS computations shall be based on the aggregate of the weighted-average outstanding shares of the constituent businesses, adjusted to equivalent shares of the surviving business for all periods presented. 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

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

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.

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. 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 : [26]

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 to the extent that they were entitled to participate in dividends. Partially paid stock subscriptions that do not share in dividends until fully paid are considered the equivalent of warrants and shall be included in diluted EPS by use of the treasury stock method. That is, the unpaid balance shall be assumed to be proceeds used to purchase stock under the treasury stock method. The number of shares included in diluted EPS shall be the difference between the number of shares subscribed and the number of shares assumed to be purchased.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

Paragraph Numbers

Appendix B: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

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

Background Information

66. In 1991, the Board issued a plan for international activities (which was updated in 1995) that describes the FASB's role in international activities and proposes steps to increase the range and intensity of its international activities. [28] An objective of the plan is to make financial statements more useful for investors and creditors by increasing the international comparability of accounting standards concurrent with improving the quality of accounting standards. One element of the plan is for the FASB to work toward greater international comparability of accounting standards by identifying projects that potentially could achieve broad international agreement in a relatively short time and by initiating cooperative international standards-setting projects.

67. An FASB Prospectus, *Earnings per Share,* was distributed for public comment in June 1993. The objective of the Prospectus was to inform the Board's constituents of a potential EPS project and to obtain information from them about the scope and importance of that project. The Prospectus explained that Opinion 15, as amended and interpreted, often had been criticized for having complex and arbitrary provisions and that, over the years, the FASB had received requests to reconsider EPS issues. In addition, it mentioned that the IASC had an EPS project on its agenda that provided an opportunity for the FASB to work with that international group toward achieving greater international comparability of EPS data.

68. The Prospectus explained that an EPS project would lend itself to a relatively narrow selection of issues and would not involve profound or divisive theoretical issues; thus, the Board concluded that an EPS project was a potential candidate for a successful cooperative international project. A majority of respondents to the Prospectus favored the Board's adding the project to its agenda in light of the agenda criteria. Most respondents indicated that the potential for international comparability should be an important consideration in the Board's agenda decision.

69. In March 1994, the Board added a project on earnings per share to its technical agenda to

be pursued concurrently with the similar project of the IASC. The objective of the project was twofold: (a) to improve and simplify U.S. generally accepted accounting principles and (b) to issue a standard that would be compatible with international standards.

70. The IASC added an EPS project to its agenda in 1989 and issued a draft Statement of Principles, *Earnings per Share,* for public comment in October 1993. In June 1994, the IASC approved a Statement of Principles to be used as the basis for an IASC Exposure Draft. In November 1995, the IASC approved an Exposure Draft of a proposed International Accounting Standard, *Earnings per Share,* which was issued in January 1996.

71. In January 1996, the FASB issued an Exposure Draft, *Earnings per Share and Disclosure of Information about Capital Structure*. Part I of the Exposure Draft proposed computation, presentation, and disclosure requirements for earnings per share by entities with publicly held common stock or potential common stock, and Part II proposed disclosures about an entity's capital structure applicable to all entities. Part I was substantially the same as the IASC Exposure Draft. The Board received 104 comment letters in response to the FASB Exposure Draft. Most letters were supportive of the proposal. The IASC received 75 comment letters in response to its Exposure Draft. The concerns raised by respondents to both Exposure Drafts and the concerns expressed by the IASC were considered by the Board at public meetings in 1996. No formal field test was conducted on the FASB Exposure Draft; however, six respondents to the Exposure Draft noted that they had applied the provisions in Part I to their company's capital structure and generally had found that the requirements were not difficult to apply and resulted in minor changes, if any, from their current EPS computations.

72. The Board decided to issue the two parts of the Exposure Draft as separate Statements because of the differences in scope. That is, the Board did not want nonpublic entities that were excluded from the scope of Part I of the Exposure Draft to have to concern themselves with numerous provisions that were not applicable to them. FASB Statement No. 129, *Disclosure of Information about Capital Structure,* was issued concurrently with this Statement. The provisions of Statement 129 are essentially unchanged from those proposed in Part II of the Exposure Draft.

73. The FASB and the IASC exchanged information on the progress of their respective EPS projects during the deliberation and redeliberation processes, and the FASB considered the tentative decisions reached by the IASC on all issues. In addition, members of the IASC Steering Committee on Earnings per Share and the IASC staff participated in FASB meetings to discuss the differences between the tentative conclusions of the two standards-setting bodies. Similarly, members of the FASB and its staff participated in IASC meetings to discuss those differences. Both the FASB and the IASC agreed to modifications of their initial positions on issues that were not considered critical. In addition, some of the conclusions reached by the FASB were influenced by how those conclusions would simplify the computation of earnings per share. The FASB decided it could reach an informed decision on the project without holding a public hearing. In January 1997, the IASC approved IAS 33, *Earnings per Share,* which was issued

about the same time as this Statement.

Benefits and Costs

74. One of the precepts of the Board's mission is to promulgate standards only when the expected benefits of the resulting information exceed the perceived costs of providing that information. The Board strives to determine that a proposed standard will fill a significant need and that the costs entailed in satisfying that need, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information.

75. The Board concluded that EPS information provided to users in financial statements could be improved by simplifying the existing computational guidance, revising the disclosure requirements, and increasing the comparability of EPS data on an international basis. Some of the changes made to the EPS guidance in an effort to simplify the computation include (a) not considering common stock equivalents in the computation of basic EPS, (b) eliminating the modified treasury stock method and the 3 percent materiality provision, and (c) revising the contingent share provisions (including eliminating the requirement to restate prior EPS data in certain situations) and the supplemental EPS data requirements.

76. The Board expects that the costs to implement this Statement will include initial costs for education and the redesign of procedures used to compute EPS data but that any ongoing costs should be minimal. The Board believes that the benefits of simplifying the EPS computation and harmonizing with national and international standards-setting bodies will outweigh the costs of implementing this Statement.

Conclusions on Basic Issues

Scope

77. This Statement, which provides computation, presentation, and disclosure requirements for earnings per share, requires presentation of earnings per share by entities with publicly held common stock or potential common stock and by entities that are in the process of selling that stock to the public. Nonpublic entities are excluded from the scope because, generally, those entities have simple capital structures and few common stockholders; thus, EPS data may not be meaningful for users of their financial statements. In addition, nonpublic entities were excluded from the scope of Opinion 15 (as amended by FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*), and the Board was not aware of any new information that would suggest that those entities should be required to report EPS data. For similar reasons, the Board decided not to include in the scope of this Statement entities whose publicly traded securities include only debt. However, any entity that chooses to present EPS data should do so in accordance with this Statement.

78. Few respondents commented on the proposed scope of the Statement. Those that did suggested that the scope exemption in the Exposure Draft for investment companies registered under the Investment Company Act of 1940 be expanded to include investment companies, such as offshore mutual funds, that are not registered under the 1940 Act but that provide the same selected per-share data (in accordance with the AICPA Audit and Accounting Guide, *Audits of Investment Companies*). The Board agreed to make that change.

Objective of the Earnings per Share Computations

79. In discussing various issues about the computation of diluted EPS, the Board found it helpful to identify the objective of both basic and diluted EPS in order to reach consistent conclusions on those issues. The Board concluded that the objective of basic EPS is to measure the performance of an entity over the reporting period and that the objective of diluted EPS should be consistent with the basic EPS objective while giving effect to all dilutive potential common shares that were outstanding during the period.

80. Other objectives of diluted EPS that the Board considered and rejected were that it should be a predictor of dilution—a forward-looking number as opposed to one based on historic numbers—or that it should maximize dilution. In concluding that diluted EPS should be an extension of basic EPS—a historic, "for the period" number—the Board looked to FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* which discusses the historical nature of accounting information, and FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* which discusses the "predictive value" of financial information. Concepts Statement 1 explains that users of financial statements may make predictions using financial information—information that is historical. Paragraph 53 of Concepts Statement 2 states in part:

> Users can be expected to favor those sources of information and analytical methods that have the greatest predictive value in achieving their specific objectives. Predictive value here means value as an *input* [emphasis in original] into a predictive process, *not value directly as a prediction.* [Emphasis added.]

81. The IASC initially concluded that the objective of diluted EPS should be to indicate the potential variability or risk attached to basic EPS as a consequence of the issue of potential common shares or to act as a warning signal of the potential dilution of basic EPS. Following that objective, diluted EPS would be computed using end-of-period shares and stock prices. The Board considers that objective to be relevant and useful but believes that it is preferable for diluted EPS to be computed in a manner consistent with the computation of basic EPS. After much discussion, the IASC agreed to require that diluted EPS be computed following the FASB objective because (a) diluted EPS computed following a performance objective can be presented in a time series and compared with diluted EPS of other periods and (b) a "warning signal" objective can be adequately conveyed through supplementary note disclosure.

82. To accommodate the concerns of the IASC, both the FASB and the IASC Exposure Drafts

included disclosure requirements related to the IASC's warning signal objective. More than half of the respondents to the FASB Exposure Draft who commented on those disclosure requirements stated that they did not believe that the warning signal objective was relevant or useful, and some found the related disclosures confusing. Respondents to the IASC Exposure Draft made similar comments; they also encouraged the IASC to choose one objective. The FASB and the IASC decided to eliminate those disclosure requirements in response to the comments received.

Basic Earnings per Share

83. One of the main objectives of the Board's project on earnings per share was to issue a standard that would be compatible with those of the IASC and national standards-setting bodies. The biggest difference between Opinion 15 and other EPS standards is that Opinion 15 required presentation of primary EPS, which includes the dilutive effect of common stock equivalents. Currently, only two other countries require that primary EPS be presented. Thus, the first issue that the Board had to address was whether to eliminate the requirement to present primary EPS and replace it with a computation that does not consider the effects of common stock equivalents.

84. In making its decision to replace primary EPS with basic EPS, the Board considered the requirements of Opinion 15 to compute primary EPS, the criticisms about primary EPS, the arguments in favor of basic EPS, and the comments it had received from constituents prior to adding the project to its agenda.

Primary Earnings per Share

85. The rules used to compute primary EPS (Opinion 15 and its amendments and interpretations) had been criticized as being extremely complex and containing a number of arbitrary provisions. Those criticisms largely focused on the determination of convertible securities as common stock equivalents, specifically, the use of the Aa corporate bond rate for the common stock equivalency test, the two-thirds yield test for common stock equivalency, and the classification of a security as a common stock equivalent at issuance without regard to later events.

86. The complexity of Opinion 15 may have contributed to errors or to inconsistency in its application. Several empirical studies indicated that EPS rules often are misunderstood by preparers and auditors and are not always applied correctly. The primary EPS statistic itself had been widely criticized as not being useful. Considerable evidence showed that many users of financial statements think that primary EPS is based on an undiluted weighted-average number of common shares outstanding; that is, they think that primary EPS is computed without giving effect to common stock equivalents.

87. Because primary EPS assumes exercise and conversion of dilutive common stock equivalents, it includes a certain amount of dilution. Some said that the endpoints on the scale of

dilution—from zero dilution to maximum dilution—would convey better information to financial statement users. Those critics said that the rules of Opinion 15 conceal part of the total potential dilution by presenting two numbers that include dilution rather than an undiluted and a diluted number.

88. Opinion 15 had drawn its strongest criticism from users (primarily financial analysts) and academics. Analysts' interest stemmed from the use of EPS in the computation of the price-earnings ratio, perhaps the most frequently cited statistic in the business of equity investment. In addition, analysts' earnings projections almost always are presented on a per-share basis. The Board did not receive many requests from other parties to comprehensively reconsider Opinion 15; therefore, it appeared that preparers and auditors had assimilated and accepted the rules. Most respondents to the EPS Prospectus agreed that basic EPS would be a simpler and more useful statistic than primary EPS. Most respondents to the Exposure Draft agreed that disclosing the full range of possible dilution using basic EPS and diluted EPS would reveal more useful information than the partial range of dilution disclosed with primary EPS and fully diluted EPS under Opinion 15. However, some respondents noted that that they did not find basic EPS to be a useful statistic and thought that users would focus only on diluted EPS.

89. The Board decided to replace primary EPS with basic EPS for the following reasons:

a. Presenting undiluted and diluted EPS data would give users the most factually supportable *range* of EPS possibilities. The spread between basic and diluted EPS would provide information about an entity's capital structure by disclosing a reasonable estimate of how much potential dilution exists.
b. Use of a common international EPS statistic has become even more important as a result of database-oriented financial analysis and the internationalization of business and capital markets.
c. The notion of common stock equivalents as used in primary EPS is viewed by many as not operating effectively in practice, and "repairing" it does not appear to be a feasible option.
d. The primary EPS computation is complex, and there is some evidence that the current guidance is not well understood and may not be consistently applied.
e. If basic EPS were to replace primary EPS, the criticisms about the arbitrary methods by which common stock equivalents are determined would no longer be an issue. If entities were required to disclose the details of their convertible securities, the subjective determination of the likelihood of conversion would be left to individual users of financial statements.

Computation of Basic Earnings per Share

Weighted-average number of shares

90. In computing basic (and diluted) EPS, the Board agreed that use of a weighted-average number of shares is necessary so that the effect of increases or decreases in outstanding shares on EPS data will be related to the portion of the period during which the related consideration

affected operations.

Contingently issuable shares

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

92. A few respondents to the Exposure Draft suggested that contingently issuable shares should never be included in the computation of basic EPS because basic EPS is supposed to be an EPS ratio with no dilution. They said that the denominator should include only actual shares outstanding. The Board considered that view but decided to retain the provision that "vested" contingently issuable shares should be considered in the computation of basic EPS because consideration for those shares has been received. The Board also agreed to retain the provision that contingently returnable shares should be treated in the same manner as contingently issuable shares. The IASC agreed to include a similar provision in IAS 33 in response to the comments received on its Exposure Draft (which did not include such a provision).

Diluted Earnings per Share

93. Securities (such as options, warrants, convertible debt, and convertible preferred stock) that do not have a current right to participate fully in earnings but that may do so in the future by virtue of their option or conversion rights are referred to in this Statement as potential common shares or potentially dilutive shares. That "potential dilution" is relevant to users because it may reduce the per-share amount of current earnings to be distributed by way of dividends in the future and may increase the number of shares over which the total market value of an entity is divided.

94. Whether option or conversion rights of potential common shares actually will be exercised is usually not determinable at an entity's reporting date. However, with the use of assumptions, it is possible to arrive at a reasonable estimate of what earnings per share would have been had common stock been issued for those securities. The Board concluded that the treasury stock method and the if-converted method prescribed in Opinion 15 should continue to be used in computing diluted EPS.

No Antidilution

95. In computing diluted EPS, only potential common shares that are dilutive—those that reduce earnings per share or increase loss per share—are included. Exercise of options and warrants or conversion of convertible securities is not assumed if the result would be

antidilutive, such as when a loss from continuing operations is reported. The sequence in which potential common shares are considered may affect the amount of dilution that they produce. The sequence of the computation was not specifically addressed in Opinion 15, but the IASC proposed that in order to maximize the dilution of earnings per share, each issue or series of potential common shares should be considered in sequence from the most dilutive to the least dilutive. The Board agreed with the IASC that that is a reasonable approach and included a similar provision in this Statement. Most respondents to the Exposure Draft agreed that sequencing potential common shares from the most dilutive to the least dilutive is a workable approach.

96. The Board also concluded that the "control number" for determining whether including potential common shares in the diluted EPS computation would be antidilutive should be *income from continuing operations* (or a similar line item above net income if it appears on the income statement). As a result, if there is a loss from continuing operations, diluted EPS would be computed in the same manner as basic EPS is computed, even if an entity has net income after adjusting for a discontinued operation, an extraordinary item, or the cumulative effect of an accounting change. Similarly, if an entity has income from continuing operations but its preferred dividend adjustment made in computing *income available to common stockholders* in accordance with paragraph 9 results in a "loss from continuing operations available to common stockholders," diluted EPS would be computed in the same manner as basic EPS.

97. If *net income* were the control number as it was under Opinion 15, diluted EPS often would be the same number as basic EPS. The Board decided to change the control number to income from continuing operations because in the United States net losses are often the result of discontinued operations, extraordinary items, or accounting changes reported by the cumulative-effect method. The Board agreed that if an entity had income from continuing operations but had an accounting change that resulted in a net loss, its diluted net loss per share *should* include potential common shares (even though their effect would be antidilutive) and should not be the same as its basic net loss per share that does not include potential common shares. With income from continuing operations as the control number, the diluted net loss per share in that case would reflect the effect of potential common shares.

98. In addition, EPS data are more comparable over time if income from continuing operations is used as the control number. That is, for an entity that reports a net loss in the period solely because of the cumulative effect of an accounting change upon adopting a new accounting standard, that period's diluted net loss per share would reflect no dilution if net income were the control number and, thus, diluted net loss per share for the period would not be comparable with past or future diluted net income per-share amounts (which would reflect some dilution). The same would be true for an entity that makes a voluntary accounting change, reports discontinued operations, or reports extraordinary items that result in a net loss.

99. Respondents to the Exposure Draft agreed with the change in the control number from *net income* under Opinion 15 to *income from continuing operations* in this Statement. The IASC did

not include a control number provision in its Exposure Draft. In response to the comments received on the FASB Exposure Draft and the few comments on the issue received in response to the IASC Exposure Draft, the IASC agreed to include a provision in IAS 33 that requires *net profit from continuing ordinary activities* to be used as the control number in establishing whether potential common shares are dilutive or antidilutive.

Options and Warrants and Their Equivalents

100. The issuance of common stock upon exercise of options and warrants produces cash inflows for the issuing entity but does not affect income. In computing earnings per share, an assumed issuance of stock increases the denominator but does not affect the numerator. The resulting reduction in earnings per share could be considered excessive if there were no adjustment for the use of the cash proceeds. The treasury stock method was meant to adjust for that situation by assuming that the cash proceeds from issuing common stock are used to acquire treasury shares. Thus, only the *net* assumed issuance of shares (common shares issued upon exercise less treasury shares acquired) is reflected in the denominator of the diluted EPS computation. Other methods that the Board considered in determining how to reflect the potential dilution of options and warrants in the computation of diluted EPS are discussed in paragraphs 101-104.

Imputed earnings method

101. Some countries use an imputed earnings method to compute diluted EPS. That method assumes that the proceeds from exercise of options and warrants are used to repay debt or are invested, for example, in government securities, rather than used to purchase treasury shares. Following the imputed earnings method, either the amount of interest that would have been saved (if the debt were repaid) or the income that would have been earned (on the investment) is added to the numerator of the computation, and the denominator is adjusted for the number of shares assumed to have been issued upon exercise of the options or warrants. The disadvantages of that method are that it requires an arbitrary assumption about the appropriate rate of earnings, it overstates dilution because it treats antidilutive potential common shares as if they were dilutive, and it gives the same effect to all options and warrants regardless of the current market price.

Treasury stock method with a discounted exercise price

102. Another method that the Board considered was to discount the expected proceeds from exercise of options or warrants with long exercise periods to reflect the time value of money prior to applying the treasury stock method. The argument for that method is that because contracts with long exercise periods are not likely to be exercised for a considerable period of time, the exercise price should be discounted to its fair value at the balance sheet date, reflecting "time value" as one component of the value of an option or warrant. The main disadvantage of that method is that the determination of (a) the time periods over which to discount the options

or warrants and (b) the applicable discount rate is subjective.

Maximum dilution method

103. The maximum dilution method assumes that all options and warrants are exercised and that the common shares issued upon exercise are added to the denominator with no change in the numerator. The principal disadvantage of that method is that an assumption that all potential common shares will convert without a change in earnings is both counterintuitive and unrealistic. It also would give the same effect to all options and warrants regardless of the current market price.

Graham-Dodd method

104. In computing diluted EPS, the Graham-Dodd method [29] takes into consideration all options and warrants, including those whose exercise price exceeds the market price of common stock. That method assumes that options and warrants are equivalent to additional outstanding common shares with the same aggregate market value as that of the options or warrants issued. The computation divides the total market value of all options and warrants by the current market price of the common stock to determine the number of additional common shares that would be equivalent to the value of outstanding options and warrants. Those additional common shares would be included in the denominator of the diluted EPS computation. In addition to showing the dilutive effect of "out of the money" options and warrants, the Graham-Dodd method reflects more dilution as the value of options and warrants increases relative to the value of common stock. That method requires the use of option-pricing models at each reporting period to value options and warrants that are not traded. [30]

Treasury stock method

105. The Board decided to retain the treasury stock method from Opinion 15 because of its use in present practice, its relative simplicity and lack of subjectivity, and its adoption by the IASC (although the method is described differently in IAS 33). The method also reflects more dilution as the value of options and warrants increases relative to the value of common stock. That is, as the average market price of the stock increases, the assumed proceeds from exercise will buy fewer shares, thus, increasing the EPS denominator. The Board was concerned that the treasury stock method understates potential dilution because it gives no dilutive effect to options and warrants whose exercise prices exceed current common stock prices and, therefore, are antidilutive under the treasury stock method but may be dilutive sometime in the future. However, the Board was unable to identify another method that would address that concern that did not have its own set of disadvantages. To offset that concern, the Board decided to require disclosure in the notes to the financial statements of potential common shares not included in the computation of dilutive EPS because their impact would be antidilutive based on current market prices.

106. Another common criticism of the treasury stock method that the Board considered is that it assumes a hypothetical purchase of treasury stock. The Board recognizes that the funds obtained by issuers from the exercise of options and warrants are used in many ways with a wide variety of results that cannot be anticipated. Application of the treasury stock method in EPS computations represents a practical approach to reflecting the dilutive effect that would result from the issuance of common stock under option and warrant agreements at an effective price below the current market price.

107. The Board made one change to the treasury stock method prescribed in Opinion 15. This Statement requires that the average stock price for the period always be used in determining the number of treasury shares assumed purchased with the proceeds from the exercise of options or warrants rather than the higher of the average or ending stock price as prescribed by Opinion 15. The Board believes that use of the average stock price is consistent with the objective of diluted EPS to measure earnings per share for the period based on period information and that use of end-of-period data or estimates of the future is inconsistent with that objective. If purchases of treasury shares actually were to occur, the shares would be purchased at various prices, not at the price at the end of the period. In addition, use of an average stock price eliminates the concern that end-of-period fluctuations in stock prices could have an undue effect on diluted EPS if an end-of-period stock price were required to be used. Respondents to the Exposure Draft generally agreed with the requirement to use the average stock price.

108. Opinion 15 required that the “modified treasury stock” method be used if the number of shares of common stock obtainable upon exercise of outstanding options and warrants in the aggregate is more than 20 percent of the number of common shares outstanding at the end of the period. The Board found that the modified treasury stock method prescribed in Opinion 15 was not widely used in practice because few entities ever met the 20 percent test. For that reason, and in an effort to simplify the EPS computation and to be consistent with the IASC Standard, the Board decided not to include that method in this Statement. Respondents to the Exposure Draft generally agreed with the elimination of the modified treasury stock method.

Stock-based compensation arrangements

109. Fixed employee stock options (fixed awards) and nonvested stock (including restricted stock) are included in the computation of diluted EPS based on the provisions for options and warrants in paragraphs 17-25. Even though their issuance may be contingent upon vesting, they are not considered to be “contingently issuable shares” as that term is used in this Statement because to consider them contingently issuable shares would be a change from present practice and the provisions of IAS 33. However, because issuance of performance-based stock options (and performance-based nonvested stock) is contingent upon satisfying conditions in addition to the mere passage of time, those options and nonvested stock are considered to be contingently issuable shares in the computation of diluted EPS. The Board decided that a distinction should be made only between time-related contingencies and contingencies requiring specific achievement.

110. The guidance in paragraph 21 for determining the assumed proceeds when applying the treasury stock method to an entity that has stock-based compensation arrangements is based on similar guidance in Statement 123, which was based on the provisions in paragraph 3 of FASB Interpretation No. 31, *Treatment of Stock Compensation Plans in EPS Computations.* The Board agreed that it would be appropriate to carry forward the remainder of the relevant guidance in paragraphs 4-6 of Interpretation 31 into this Statement. That guidance has been incorporated into paragraphs 20, 22, and 29 of this Statement. Examples 1 and 2 from Appendix B of Interpretation 31 are included in Illustration 8 in Appendix C.

Written put options and purchased options

111. A number of respondents to the Exposure Draft requested that the Board address how written put options, purchased put options, and purchased call options should be included in the computation of diluted EPS. Emerging Issues Task Force (EITF) Issue No. 87-31, "Sale of Put Options on Issuer's Stock," addresses put options sold by a company for cash that enable the holder to sell shares of the company's stock at a fixed price to the company. The EITF reached a consensus that the reverse treasury stock method should be used in computing the impact of those options on earnings per share. Under that method, the incremental number of shares to be added to the denominator is computed as the excess of shares that will be issued for cash at the then current market price to obtain cash to satisfy the put obligation over the shares received from satisfying the puts. The Board agreed to include that approach in this Statement for "in the money" contracts that require that the reporting entity repurchase its own stock.

112. The Board concluded that neither purchased put options nor purchased call options should be reflected in diluted EPS because their effect would be antidilutive. A few respondents stated that entities should be permitted to aggregate the calls held by an entity on its own stock (purchased calls) with the options or warrants it is attempting to hedge. Those respondents suggested that the Board modify the treasury stock method to require that proceeds assumed to be received from the exercise of options be used to pay the strike price on the call option that the entity holds on its own stock (rather than assume that the proceeds received will be used to purchase treasury shares as required by the treasury stock method). The Board confirmed its position that securities that would have an antidilutive effect should not be included in the diluted EPS computation and that securities should be considered separately rather than in the aggregate in determining whether their effect on diluted EPS would be dilutive or antidilutive.

Convertible Securities

113. Other securities that could result in the issuance of common shares, in addition to options and warrants, are debt and preferred stock that are convertible into common stock. The impact of those potential common shares on diluted EPS is determined by use of the if-converted method. That method recognizes that the holders of convertible preferred stock cannot share in distributions of earnings available to common stockholders unless they relinquish their right to senior distributions. Conversion is assumed, and income available to common stockholders is

determined before distributions are made to holders of those securities. Likewise, the if-converted method recognizes that convertible debt can participate in earnings through interest or dividends, either as a senior security or as common stock, but not both.

114. The Board chose to retain the if-converted method prescribed in Opinion 15 in this Statement. There have been few criticisms of that method, and it is the method used by the IASC. One common criticism of the if-converted method is that conversion may be assumed when a convertible security appears likely to remain a senior security.

Contracts That May Be Settled in Stock or Cash

115. As discussed in paragraph 110, the guidance in Interpretation 31 has been brought forward into this Statement. Paragraph 6 of that Interpretation established a rebuttable presumption that when stock appreciation rights and other variable plan awards may be settled in stock or cash (at the election of either the holder or the reporting entity), the entity should presume settlement in common stock and the dilutive potential common shares should be included in the EPS computation unless the presumption is overcome. The Board agreed that that guidance was equally appropriate for other contracts that could be settled in stock or cash and thus included that guidance in paragraph 29 of this Statement. The Board believes that that approach is consistent with the objective of diluted EPS to reflect potential dilution that existed during the period. In circumstances in which the contract is reported as an asset or liability for accounting purposes (as opposed to an equity instrument) but the contract is presumed to be settled in common stock for EPS purposes, the Board believes it is appropriate to adjust income available to common shareholders for any changes in the fair value of the contract that had been recognized in income. Although all such contracts that provide the issuer or holder with a choice between settlement methods may not meet the definition of an option, warrant, convertible security, or contingently issuable share, they do meet the definition of potential common stock in paragraph 171 of this Statement.

Contingently Issuable Shares

116. In discussing the issue of the impact of contingently issuable shares on diluted EPS, the Board chose not to retain the requirements in Opinion 15 to (a) increase the numerator of the computation for possible future earnings levels and (b) restate prior EPS data for differences in actual and assumed earnings levels. The Board concluded that making assumptions about future earnings and restating for events that occur after the end of a period would be inconsistent with a "historic" objective. Thus, the Board decided to include contingently issuable shares in the computation of diluted EPS based only on current earnings (which are assumed to remain unchanged until the end of the contingency period) and to prohibit restatement.

117. The Board also was not in favor of permitting restatement of EPS data due to changes in market prices. The Board noted that restatement was prohibited for the impact of changes in market prices on the number of shares included in the denominator as a result of applying the

treasury stock method. The Board decided to include shares contingent on market price in diluted EPS based on the end-of-period market price and to prohibit restatement.

118. Contingent stock agreements sometimes provide for shares to be issued in the future pending the satisfaction of conditions unrelated to earnings or market value (for example, opening a certain number of retail locations). Similar to its other conclusions, the Board decided (a) to include contingent shares 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 and (b) to prohibit restatement. Thus, if only half of the requisite retail locations have been opened, then no contingent shares would be included in the diluted EPS computation.

119. The Board considered including contingent shares on a pro rata basis based on the current status of the condition (such as half of the contingent shares for the example in paragraph 118). However, the Board was concerned that a pro rata approach would not be implemented easily and that it might make little sense in many instances, such as when it is readily apparent that the condition will not be met.

120. Some Board members were concerned about the inconsistency in when compensation cost for performance awards is included in the numerator of the diluted EPS computation (pursuant to Statement 123) and when the related contingent shares are included in the denominator of the same computation (pursuant to this Statement). The initial accruals of compensation cost for performance awards are based on the best estimate of the outcome of the performance condition. That is, compensation cost is estimated at the grant date for the options that are expected to vest based on performance-related conditions and that are accrued over the vesting period. However, pursuant to this Statement, diluted EPS would reflect only those shares (stock options) that would be issued if the end of the reporting period were the end of the contingency period. In most cases, performance awards will not be reflected in diluted EPS until the performance condition has been satisfied. The Board observed that (a) the focus of this Statement is the denominator of the EPS computation, not the determination of earnings, and (b) that treatment is consistent with current practice when compensation is associated with a contingent award.

121. Most respondents to the Exposure Draft agreed with the changes proposed for contingent stock agreements. A few respondents requested that the Board clarify as of what date contingently issuable shares should be included in the computations of basic and diluted EPS. The Board concluded that contingent shares should be deemed to be issued when all of the necessary conditions have been met and that those shares should be included in basic EPS on a weighted-average basis. In most cases, the shares would be included only as of the last day of the period because whether the condition has been satisfied may not be certain until the end of the period. The Board concluded that contingent shares should be included in the denominator of the diluted EPS computation in a manner similar to other potential common shares; that is, as if the shares were issued at the beginning of the period (or as of the date of the contingent stock agreement, if later). However, for year-to-date computations, the Board agreed that contingent shares should be included on a weighted-average basis. That approach is similar to the method

used for including incremental shares in year-to-date computations when applying the treasury stock method.

Presentation on Face of Income Statement

122. The Board agreed that EPS data should be presented prominently in the financial statements because of the significance attached by investors and others to EPS data and because of the importance of evaluating the data in conjunction with the financial statements. Thus, the Board concluded that both basic and diluted per-share amounts should be presented on the face of the income statement for income from continuing operations and net income. The Board agreed that, at a minimum, those per-share amounts should be presented on the face of the income statement to help users determine the impact of items reported "below-the-line."

123. The Board decided to give entities the option of presenting basic and diluted per-share amounts for discontinued operations, extraordinary items, and the cumulative effect of an accounting change either on the face of the income statement or in the notes to financial statements to address the concern that some constituents had with excessive information on the income statement. The extent of the data presented and the captions used will vary with the complexity of an entity's capital structure and the presence of transactions outside continuing operations.

124. The IASC Exposure Draft required presentation of only basic and diluted net income per share on the face of the income statement and encouraged presentation of other per-share amounts. Most respondents to the FASB Exposure Draft agreed with the requirements related to presentation of per-share amounts on the face of the income statement and in the notes to the financial statements and stated that the IASC should adopt the FASB's presentation approach. The IASC decided not to change its presentation requirements in its EPS standard but acknowledged that it will have to address presentation of per-share amounts other than net income per share as part of other related projects on its agenda.

125. The June 1996 FASB Exposure Draft, *Reporting Comprehensive Income*, would require presentation of a per-share amount for comprehensive income on the face of the statement of financial performance in which comprehensive income is reported. Per-share amounts are not required by that Exposure Draft for subtotals resulting from classifications within other comprehensive income. If that Exposure Draft is finalized as proposed, the Board will have to determine how comprehensive income per share should be computed to be in accordance with the provisions of this Statement.

126. The Board's decision to require a dual EPS presentation (basic and diluted EPS) for entities with complex capital structures regardless of the variance between basic and diluted EPS is a change from Opinion 15. Opinion 15 provided that fully diluted EPS did not have to be presented if the dilution caused by including all potential common shares in the computation was less than 3 percent of "simple" EPS, which includes no dilution. Similarly, primary EPS could be presented as simple EPS if the dilution caused by including common stock equivalents in the

computation was less than 3 percent of simple EPS.

127. The Board decided to eliminate what is referred to as the “materiality threshold” for presentation of diluted EPS because (a) the requirement was used inconsistently, (b) in many cases, an entity had to compute fully diluted EPS to determine whether it met the 3 percent test, and (c) in any period that an entity’s earnings per share fell out of the 3 percent range, Opinion 15 required fully diluted EPS to be shown for all periods presented. The Board concluded that requiring a dual presentation at all times by all entities with complex capital structures places all of the facts in the hands of users of financial statements at minimal or no cost to preparers and gives users an understanding of the extent and trend of potential dilution. The Board also noted that many entities currently present fully diluted EPS even when it does not differ by 3 percent from simple or primary EPS because when fully diluted EPS is compared over time, small differences may be relevant in assessing relative changes between periods.

128. Most respondents to the Exposure Draft agreed with the Board’s conclusion that presenting both basic and diluted EPS on the face of the income statement would result in minimal or no additional cost to the preparer. However, many of those respondents requested that the Board retain a materiality threshold similar to that in Opinion 15. They stated that presentation of diluted EPS when it is not materially different from basic EPS is an immaterial disclosure that could cause confusion (that is, multiple EPS amounts on the face of the income statement might be confusing to users). Some respondents also stated that the marginal costs of dual presentation would exceed the marginal benefits to the user community.

129. Because of those comments and the view of some respondents that diluted EPS is the more useful statistic, the Board initially decided that if only one per-share amount were to be required to be presented on the face of the income statement it should be diluted EPS, not basic EPS. The Board reasoned that a single presentation would eliminate any confusion that unsophisticated users might have with multiple EPS amounts and any confusion over which EPS number databases should include. In addition, presenting only diluted EPS on the face of the income statement would display the most meaningful information in the primary financial statements and would be another step toward simplification of the EPS guidance. The Board acknowledged the usefulness of providing a range of potential dilution and, therefore, agreed to retain the requirement that basic EPS should be presented in the notes to the financial statements as part of the required reconciliation of basic and diluted EPS.

130. Because of the international harmonization goal of the project, the FASB presented its initial decisions on income statement presentation to the IASC Steering Committee on Earnings per Share and the IASC Board in September 1996 as preliminary conclusions. The FASB indicated that it would reconsider those decisions based on the IASC’s level of support for making similar changes to its proposed standard. The IASC decided to retain its requirement for equal prominence of basic and diluted EPS on the face of the income statement because it believes that there is valuable information content in the difference between the two numbers. The users in the United States with whom the FASB discussed its preliminary conclusions

shared that view.

131. In the interest of international harmonization, the Board ultimately decided to retain the dual presentation requirement proposed in the Exposure Draft. The Board acknowledged that if it were to stay with its "diluted EPS only" preliminary conclusion, the resulting FASB and IASC EPS standards would have been substantially the same because EPS would be *computed* in the same manner even though it would not be *presented* in the same manner. However, the Board believes it is most important to achieve harmonization in all aspects with the IASC, especially because the difference is only one of display, not one of a conceptual nature.

132. Consequently, both the FASB and the IASC agreed that dual presentation of basic and diluted EPS should be required in all instances, regardless of the difference between the two numbers. As noted in paragraph 89(a), the Board believes that, when compared with diluted EPS, basic EPS is useful as a benchmark for determining the amount of potential dilution. If basic and diluted EPS are the same amount, dual presentation can be accomplished in one line on the income statement. In response to the concerns of some respondents to the Exposure Draft that removal of the 3 percent materiality threshold will result in more variations in the concept of materiality than currently exists, the Board noted that the materiality box that states "The provisions of this Statement need not be applied to immaterial items" does not apply to the difference between two numbers.

Conclusions on Other Issues

Stock Dividends or Stock Splits

133. This Statement requires an entity that has a stock dividend, stock split, or reverse stock split after the close of the period but before issuance of the financial statements to compute basic and diluted EPS in those financial statements based on the new number of shares because those per-share amounts would have to be restated in the subsequent period. The IASC Exposure Draft proposed computing earnings per share in those situations based on the shares actually existing at the date of the financial statements. It also proposed disclosing a description of the subsequent event and pro forma EPS amounts in the financial statements of the period prior to the actual event.

134. Most respondents to the FASB Exposure Draft preferred the FASB restatement requirement over the IASC disclosure approach. Those respondents noted that reflecting the subsequent event in the current period would provide more useful, relevant, and meaningful information and would obviate the need for later restatement. In response to the comments it received on that issue and in the interest of harmonization, the IASC agreed to change from a disclosure approach to a requirement to restate, similar to that in this Statement.

Rights Issues

135. The IASC Exposure Draft proposed using the "theoretical ex-rights method" for adjusting EPS data for a bonus element contained in a rights issue offered to all existing stockholders. The FASB Exposure Draft proposed that the treasury stock method be used for making that adjustment. The Board initially decided not to use the IASC's proposed method because of the complexity of that method and the familiarity in the United States with the treasury stock method and because the treasury stock method achieves quite similar results. As noted by a few respondents to the Exposure Drafts, rights offerings are much more common outside the United States and use of the ex-rights method is established in international practice. In the interest of harmonization, the Board decided to accept the IASC's position on that issue and require use of the ex-rights method when adjusting both basic and diluted EPS for the bonus element in a rights issue.

Supplemental Earnings per Share Data

136. Opinion 15 required disclosure of supplemental EPS data. The purpose of those disclosures was to show what primary EPS would have been if the conversions or sales of securities had occurred at the beginning of the period being reported on rather than during the period. The Board concluded that requiring disclosure of similar information in this Statement was not consistent with the objective of basic and diluted EPS and, thus, decided not to include that requirement in this Statement. However, the Board agreed that it would be useful for financial statements to include a description of transactions that occur after the balance sheet date but before issuance of the financial statements that would have resulted in a material change in the number of common or potential common shares outstanding at the end of the period. Including that information will provide those that want to compute "pro forma" EPS information with the necessary data. Some respondents to the Exposure Draft suggested that information about post-balance-sheet transactions that occurred in periods other than the most recent period would not be useful. The Board decided to require disclosure of that information only for the current reporting period rather than, as proposed in the Exposure Draft, for all periods for which an income statement is presented.

Disclosure Requirements

137. The Board decided to require a reconciliation of the numerators and denominators of the basic and diluted EPS computations in this Statement because the reconciliation is simple and straightforward and will help users better understand the dilutive effect of certain securities included in the EPS computations. SEC Regulation S-K requires presentation of a statement that reasonably details the computation of earnings per share unless the computation can be clearly determined from the material contained in the annual report. The reconciliation required by this Statement should satisfy the SEC requirement and should not result in additional costs to preparers. The Board agreed that disclosing the nature and impact of each dilutive potential common share (or series of shares) included in the diluted EPS computation, as well as separately identifying those antidilutive potential common shares that could dilute earnings per

share in the future, allows users to exercise their own judgment as to the "likely" EPS number.

138. Some respondents to the Exposure Draft did not support the reconciliation requirement and stated that (a) the costs to prepare it would exceed the benefit to users, (b) it would be complex and confusing, and (c) it is already required by the SEC. A number of respondents observed that the SEC has proposed eliminating its similar reconciliation requirement in Regulation S-K. The SEC has decided to postpone acting on that proposal in light of comments it has received regarding the usefulness of the reconciliation to investors and financial analysts and the similar proposed requirement in the FASB Exposure Draft. The comments received by the SEC reinforced the Board's position that the reconciliation contains information that is very useful to users of financial statements. However, in response to some of the comments it received, the Board agreed that insignificant reconciling items need not be itemized as part of the reconciliation and could be combined (aggregated).

139. The Exposure Draft would have required disclosure of information that would assist users of financial statements in assessing how basic EPS may be affected in the future due to the potential common shares still outstanding at the balance sheet date as well as the common stock price at that date. Those requirements were referred to as the "warning signal" disclosures because they were meant to address the IASC's warning signal objective for diluted EPS. However, as noted in paragraph 82, many respondents who commented on the warning signal disclosure requirement in the Exposure Draft stated that they did not believe that the warning signal objective was relevant or useful, and some found the related disclosures confusing. Those respondents generally stated that the costs of the related disclosures would exceed the benefits and that those disclosures would be too complex. A number of respondents to the IASC Exposure Draft made similar comments, and some suggested that the disclosure requirement be made optional. Respondents also noted that some of the information is already required to be disclosed in the financial statements pursuant to other IASC standards. After reconsideration, both the FASB and the IASC agreed to eliminate the warning signal disclosure requirements from their respective standards.

Securities of Subsidiaries

140. This Statement is based on the current practice of deducting income attributable to the noncontrolling interest (minority interest) to arrive at consolidated net income in the consolidated financial statements. The October 1995 FASB Exposure Draft, *Consolidated Financial Statements: Policy and Procedures,* would change that practice to require that net income attributable to the noncontrolling interest be deducted from consolidated net income to arrive at an amount called *net income attributable to the controlling interest.* In addition, that Exposure Draft states that the computation of earnings per share in consolidated financial statements that include subsidiaries that are not wholly owned should be based on and designated as the amount of net income attributable to the controlling interest. Although consolidated net income would include the results of all consolidated operations, the EPS computation would continue to be based only on net income attributable to the controlling interest.

141. The consolidations Exposure Draft would not require disclosure of "income from continuing operations attributable to the controlling interest" if a noncontrolling interest exists. If that Exposure Draft is finalized as proposed, the Board will have to determine what the control number should be for entities that are required to present earnings per share for net income attributable to the controlling interest. Those and other related issues will be addressed before the Board finalizes its redeliberations on the proposed Statement on consolidated financial statements.

Effective Date and Transition

142. The Board decided that this Statement should be effective for financial statements issued for periods ending after December 15, 1997, including interim periods. The Board believes that that effective date provides adequate time for entities to make any needed modifications to their systems and procedures to conform with the provisions of this Statement. For comparability, the Board decided to require restatement of all prior-period EPS data presented (including interim and summary financial information) in the period of adoption.

143. Earnings per share is a widely quoted statistic; therefore, to enhance comparability among entities, the Board decided to prohibit early adoption of this Statement. Thus, entities are prohibited from presenting EPS data computed in accordance with this Statement on the face of the income statement prior to the required adoption date. However, the Board decided to permit entities to disclose pro forma EPS data in the notes to the financial statements prior to that date.

144. Most respondents to the Exposure Draft agreed with the proposed effective date; however, some respondents suggested that this Statement be effective as of the beginning of the year (for calendar-year entities) rather than as of the end of the year. Most respondents agreed with the Board that the benefits of restatement would exceed the related costs and that both the requirement to restate and the prohibition on early adoption would enhance the consistency and comparability of financial reporting. Due to the prohibition on early adoption, the Board decided to retain the effective date proposed in the Exposure Draft so that calendar-year entities will not have to wait until 1998 to adopt this Statement. That is, calendar-year entities will have to implement the Statement in the fourth quarter of 1997 (and restate back to January 1, 1997). An entity with a June 30, 1997 year-end will have to implement the Statement in its second quarter, the quarter ending December 31, 1997 (and restate its first-quarter results).

145. Some respondents indicated that restatement of all EPS data presented would be impracticable in some situations, especially for entities that present tables of 10-year selected data or that have had a number of changes in capital structure due to mergers or acquisitions. The Board acknowledged that it might be difficult to restate EPS data for 10 years, especially if there have been changes in capital structures. However, the Board decided to retain the requirement for restatement because it believes that the benefits far outweigh the costs. In conjunction with that decision, the Board noted that this Statement does not require presentation

of EPS data for 10 years. It requires only that if EPS data are presented, those data must be computed in accordance with the provisions of this Statement. Thus, entities that choose to present EPS data in summaries of earnings or selected financial data must restate that EPS data.

Other Literature on Earnings per Share

146. A number of respondents to the Exposure Draft suggested that the Board address changes to or continuation of other authoritative guidance on earnings per share, including that of the SEC and the EITF. Because one of the objectives of the EPS project was to simplify the EPS literature, the Board agreed to include in this Statement a table listing all non-FASB authoritative EPS literature and this Statement's impact, if any, on that literature. That table is presented in Appendix F as a reference tool. The Board did not deliberate any of the issues discussed in the other literature, except where specifically noted.

Appendix C

ILLUSTRATIONS

CONTENTS

Appendix C: ILLUSTRATIONS

Introduction

147. This appendix illustrates this Statement's application to entities with complex capital structures. Certain assumptions have been made to simplify the computations and focus on the issue at hand in each illustration.

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

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

Average market price of common stock. The average market prices of common stock for the calendar-year 20X1 were as follows:

First quarter	$59
Second quarter	$70
Third quarter	$72
Fourth quarter	$72

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

Common stock. The number of shares of common stock outstanding at the beginning of 20X1 was 3,300,000. On March 1, 20X1, 100,000 shares of common stock were issued for cash.

Convertible debentures. In the last quarter of 20X0, 4 percent convertible debentures with a principal amount of $10,000,000 due in 20 years were sold for cash at $1,000 (par). Interest is payable semiannually on November 1 and May 1. Each $1,000 debenture is convertible into 20 shares of common stock. No debentures were converted in 20X0. The entire issue was converted on April 1, 20X1, because the issue was called by the Corporation.

Convertible preferred stock. In the second quarter of 20X0, 600,000 shares of convertible preferred stock were issued for assets in a purchase transaction. The quarterly dividend on each share of that convertible preferred stock is $0.05, payable at the end of the quarter. Each share is convertible into one share of common stock. Holders of 500,000 shares of that convertible preferred stock converted their preferred stock into common stock on June 1, 20X1.

Warrants. Warrants to buy 500,000 shares of common stock at $60 per share for a period of 5 years were issued on January 1, 20X1. All outstanding warrants were exercised on September 1, 20X1.

Options. Options to buy 1,000,000 shares of common stock at $85 per share for a period of 10 years were issued on July 1, 20X1. No options were exercised during 20X1 because the exercise price of the options exceeded the market price of the common stock.

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

Year 20X1	**Income (Loss) before Extraordinary Item and Accounting Change**[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)	3,750,000[c]
Full year	$7,500,000	$ 9,750,000

[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]Corporation A had a $4.25 million cumulative effect of an accounting change (net of tax) in the fourth quarter.

First Quarter 20X1

Basic EPS Computation

Net income	$3,000,000
Less: Preferred stock dividends	(30,000)[a]
Income available to common stockholders	$2,970,000

Dates Outstanding	**Shares Outstanding**	**Fraction of Period**	**Weighted-Average Shares**
January 1–February 28	3,300,000	2/3	2,200,000
Issuance of common stock on March 1	100,000		

March 1–March 31	3,400,000	1/3	1,133,333
Weighted-average shares			3,333,333

Basic EPS $0.89

The equation for computing basic EPS is:

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

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[a]600,000 shares × $0.05

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:

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

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[a]600,000 shares × $0.05

[b]($10,000,000 × 4%) ÷ 4; less taxes at 40%

[c]The warrants were not assumed exercised because they were antidilutive in the period ($60 exercise price > $59 average price).

Second Quarter 20X1

Basic EPS Computation

Net income	4,500,000
Less: Preferred stock dividends	(5,000)[a]
Income available to common stockholders	$4,495,000

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
April 1	3,400,000		
Conversion of 4% debentures on April 1	200,000		
April 1–May 31	3,600,000	2/3	2,400,000
Conversion of preferred stock on June 1	500,000		
June 1–June 30	4,100,000	1/3	1,366,667
Weighted-average shares			3,766,667

Basic EPS $1.19

The equation for computing basic EPS is:

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

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[a]100,000 shares × $0.05

Second Quarter 20X1

Diluted EPS Computation

Income available to common stockholders		$4,495,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	$ 5,000[a]	
Effect of assumed conversions		5,000
Income available to common stockholders + assumed conversions		$4,500,000
Weighted-average shares		3,766,667
Plus: Incremental shares from assumed conversions		
Warrants	71,429[b]	
Convertible preferred stock	433,333[c]	
Dilutive potential common shares		504,762
Adjusted weighted-average shares		4,271,429

Diluted EPS $1.05

The equation for computing diluted EPS is:

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

[a]100,000 shares × $0.05

[b]$60 × 500,000 = $30,000,000; $30,000,000 ÷ $70 = 428,571; 500,000 - 428,571 = 71,429 shares **OR** [($70 – $60) ÷ $70] × 500,000 shares = 71,429 shares

[c](600,000 shares × 2/3) + (100,000 shares × 1/3)

Third Quarter 20X1

Basic EPS Computation

Income before extraordinary item	$ 500,000
Less: Preferred stock dividends	(5,000)
Income available to common stockholders	495,000
Extraordinary item	(2,000,000)
Net loss available to common stockholders	$(1,505,000)

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
July 1-August 31	4,100,000	2/3	2,733,333
Exercise of warrants on September 1	500,000		
September 1–September 30	4,600,000	1/3	1,533,333
Weighted-average shares			4,266,666

Basic EPS

Income before extraordinary item	**$ 0.12**
Extraordinary item	**$(0.47)**
Net loss	**$(0.35)**

The equation for computing basic EPS is:

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

Third Quarter 20X1

Diluted EPS Computation

Income available to common stockholders		$ 495,000
Plus: Income impact of assumed conversions		
Preferred stock dividends	$ 5,000	
Effect of assumed conversions		5,000
Income available to common stockholders + assumed conversions		500,000
Extraordinary item		(2,000,000)
Net loss available to common stockholders + assumed conversions		$(1,500,000)
Weighted-average shares		4,266,666
Plus: Incremental shares from assumed conversions		
Warrants	51,643[a]	
Convertible preferred stock	100,000	

Dilutive potential common shares	151,643
Adjusted weighted-average shares	4,418,309

Diluted EPS

Income before extraordinary item	**$ 0.11**
Extraordinary item	**$(0.45)**
Net loss	**$(0.34)**

The equation for computing diluted EPS is:

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

Note: The incremental shares from assumed conversions are included in computing the diluted per-share amounts for the extraordinary item and net loss even though they are antidilutive. This is because the control number (income before extraordinary item, adjusted for preferred dividends) was income, not a loss. (Refer to paragraphs 15 and 16.)

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[a][($71 - $60) ÷ $71] × 500,000 = 77,465 shares; 77,465 × 2/3 = 51,643 shares

Fourth Quarter 20X1

Basic and Diluted EPS Computation

Loss before accounting change	$ (500,000)
Plus: Preferred stock dividends	(5,000)
Loss available to common stockholders	(505,000)
Accounting change	4,250,000
Net income available to common stockholder	$3,745,000

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
October 1–December 31	4,600,000	3/3	4,600,000

Weighted-average shares	4,600,000

Basic and Diluted EPS

Loss before accounting change	**$(0.11)**
Accounting change	**$ 0.92**
Net income	**$ 0.81**

The equation for computing basic (and diluted) EPS is:

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

Note: The incremental shares from assumed conversions are not included in computing the diluted per-share amounts for the accounting change and net income because the control number (loss before accounting change, adjusted for preferred dividends) was a loss, not income. (Refer to paragraphs 15 and 16.)

Full Year 20X1

Basic EPS Computation

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

Dates Outstanding	Shares Outstanding	Fraction of Period	Weighted-Average Shares
January 1–February 28	3,300,000	2/12	550,000
Issuance of common stock on March 1	100,000		
March 1–March 31	3,400,000	1/12	283,333

Conversion of 4% debenture on April 1	200,000		
April 1–May 31	3,600,000	2/12	600,000
Conversion of preferred stock on June 1	500,000		
June 1–August 31	4,100,000	3/12	1,025,000
Exercise of warrants on September 1	500,000		
September 1–December 31	4,600,000	4/12	1,533,333
Weighted-average shares			3,991,666

Basic EPS

Income before extraordinary item and accounting change	**$ 1.87**
Extraordinary item	**$(0.50)**
Accounting change	**$ 1.06**
Net income	**$ 2.43**

The equation for computing basic EPS is:

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

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)
Accounting change		4,250,000
Net income available to common stockholders + assumed conversions		$ 9,810,000

Weighted-average shares		3,991,666
Plus: Incremental shares from assumed conversions		
Warrants	30,768[a]	
Convertible preferred stock	308,333[b]	
4% convertible debentures	50,000[c]	
Dilutive potential commons shares		389,101
Adjusted weighted-average shares		4,380,767

Diluted EPS

Income before extraordinary item and accounting change	**\$ 1.73**
Extraordinary item	**\$(0.46)**
Accounting change	**\$ 0.97**
Net income	**\$ 2.24**

The equation for computing diluted EPS is:

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

[a](71,429 shares × 3/12) + (51,643 shares × 3/12)

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

[c]200,000 shares × 3/12

149. The following illustrates how Corporation A might present its EPS data on its income statement. Note that the per-share amounts for the extraordinary item and the accounting change are not required to be shown on the face of the income statement.

	For the Year Ended 20X1
Earnings per common share	
Income before extraordinary item and accounting change	\$ 1.87
Extraordinary item	(0.50)
Cumulative effect of a change in accounting principle	1.06

Net income	$ 2.43

Earnings per common share—assuming dilution

Income before extraordinary item and accounting change	$ 1.73
Extraordinary item	(0.46)
Cumulative effect of a change in accounting principle	0.97
Net income	$ 2.24

150. The following table includes the quarterly and annual EPS data for Corporation A. The purpose of this table is to illustrate that the sum of the four quarters' EPS data will not necessarily equal the annual EPS data. This Statement does not require disclosure of this information.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Basic EPS					
Income (loss) before extraordinary item and accounting change	$0.89	$1.19	$ 0.12	$(0.11)	$ 1.87
Extraordinary item	—	—	(0.47)	—	(0.50)
Accounting change	—	—	—	0.92	1.06
Net income (loss)	$0.89	$1.19	$(0.35)	$ 0.81	$ 2.43
Diluted EPS					
Income (loss) before extraordinary item and accounting change	$0.74	$1.05	$ 0.11	$(0.11)	$ 1.73
Extraordinary item	—	—	(0.45)	—	(0.46)
Accounting change	—	—	—	0.92	0.97
Net income (loss)	$0.74	$1.05	$(0.34)	$ 0.81	$ 2.24

Illustration 2—Earnings per Share Disclosures

151. The following is an illustration of the reconciliation of the numerators and denominators of the basic and diluted EPS computations for "income before extraordinary item and accounting change" and other related disclosures required by paragraph 40 for Corporation A in Illustration 1. **Note:** Statement 123 has specific disclosure requirements related to 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	
Convertible preferred stock	45,000	308,333	
4% convertible debentures	60,000	50,000	
Diluted EPS			
Income available to common stockholders + assumed conversions	$7,560,000	4,380,767	$1.73

Options to purchase 1,000,000 shares of common stock at $85 per share were outstanding during the second half of 20X1 but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares. The options, which expire on June 30, 20Y1, were still outstanding at the end of year 20X1.

Illustration 3—Contingently Issuable Shares

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

- Corporation B had 100,000 shares of common stock outstanding during the entire year ended December 31, 20X1. It had no options, warrants, or convertible securities outstanding during the period.
- Terms of a contingent stock agreement related to a recent business combination provided the following to certain shareholders of the Corporation:
  - 1,000 additional common shares for each new retail site opened during 20X1

- 5 additional common shares for each $100 of consolidated, after-tax net income in excess of $500,000 for the year ended December 31, 20X1.

- The Corporation opened two new retail sites during the year:
  - One on May 1, 20X1
  - One on September 1, 20X1.
- Corporation B's consolidated, year-to-date after-tax net income was:
  - $400,000 as of March 31, 20X1
  - $600,000 as of June 30, 20X1
  - $450,000 as of September 30, 20X1
  - $700,000 as of December 31, 20X1.

Note: In computing diluted EPS for an interim period, contingent shares are included as of the beginning of the period. For year-to-date computations, footnote 18 of this Statement requires that contingent shares be included on a weighted-average basis.

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

	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**Full Year**
Diluted EPS Computation					
Numerator	$400,000	$200,000	$(150,000)	$250,000	$700,000
Denominator:					
Common shares outstanding	100,000	100,000	100,000	100,000	100,000
Retail site contingency	0	1,000	2,000	2,000	1,250[e]
Earnings contingency	0[f]	5,000[g]	0[h]	10,000[i]	3,750[j]
Total shares	100,000	106,000	102,000	112,000	105,000

Diluted EPS	$ 4.00	$ 1.89	$ (1.47)[k]	$ 2.23	$ 6.67

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[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

[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

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

Illustration 4—Antidilution Sequencing

153. 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 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.

Determination of Earnings per Incremental Share

	Increase in Income	Increase in Number of Common Shares	Earnings per Incremental Share
Options	0	20,000[a]	—
Convertible preferred stock	$6,400,000[b]	1,600,000[c]	$4.00
5% convertible debentures	3,000,000[d]	2,000,000[e]	1.50

Computation of Diluted Earnings per Share

	Income Available	Common Shares	Per Share	
As reported	$10,000,000	2,000,000	$5.00	
Options	0	20,000		
	10,000,000	2,020,000	4.95	Dilutive
5% convertible debentures	3,000,000	2,000,000		
	13,000,000	4,020,000	3.23	Dilutive
Convertible preferred stock	6,400,000	1,600,000		
	$19,400,000	5,620,000	3.45	Antidilutive

Note: Because diluted EPS *increases* from $3.23 to $3.45 when convertible preferred shares are included in the computation, those convertible preferred shares are antidilutive and are ignored in the computation of diluted EPS. Therefore, diluted EPS is reported as $3.23.

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[a] [($75 - $60) ÷ $75] × 100,000

[b] 800,000 shares × $8

[c] 800,000 shares × 2

[d] ($100,000,000 × 5%) less taxes at 40%

[e] 100,000 debentures × 20

Illustration 5—Rights Issues

154. The following example illustrates the provisions for stock rights issues that contain a bonus element as described in paragraphs 55 and 56. The facts assumed are as follows:

- Net income was $1,100 for the year ended December 31, 20X0.
- 500 common shares were outstanding for the entire year ended December 31, 20X0.
- A rights issue was offered to all existing shareholders in January 20X1. The last date to exercise the rights was March 1, 20X1. The offer provided 1 common share for each 5 outstanding common shares (100 new shares).
- The exercise price for the rights issue was $5 per share acquired.
- The fair value of 1 common share was $11 at March 1, 20X1.
- Basic EPS for the year 20X0 (prior to the rights issuance) was $2.20.

As a result of the bonus element in the January 20X1 rights issue, basic and diluted EPS for 20X0 will have to be adjusted retroactively. The number of common shares used in computing basic and diluted EPS is the number of shares outstanding immediately prior to the rights issue (500) multiplied by an *adjustment factor*. Prior to computing the adjustment factor, the *theoretical ex-rights fair value per share* must be computed. Those computations follow:

Theoretical ex-rights fair value per share[a]	$10	=	$\dfrac{(500 \times \$11) + (100 \times \$5)}{(500 + 100)}$
Adjustment factor[b]	1.1	=	$11 ÷ $10
Denominator for restating basic EPS	550	=	500 × 1.1
Restated basic EPS for 20X0	$2.00	=	$1,100 ÷ 550

Diluted EPS would be adjusted retroactively by adding 50 shares to the denominator that was used in computing diluted EPS prior to the restatement.

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[a]The equation for computing the theoretical ex-rights fair value per share is:

$$\frac{\text{Aggregate fair value of shares prior to exercise of rights + Proceeds from exercise of rights}}{\text{Total shares outstanding after exercise of rights}}$$

[b]The equation for computing the adjustment factor is:

$$\frac{\text{Fair value per share immediately prior to exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

Illustration 6—Two-Class Method

155. 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

Illustration 7—Securities of a Subsidiary: Computation of Basic and Diluted Earnings per Share

156. 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. This example is based on current practice. Based on the provisions in the consolidations Exposure Draft, the presentation of earnings per share would differ from that illustrated in this example for an entity that includes subsidiaries that are not wholly owned. 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 exercisable to purchase 200 shares of its common stock at $10 per share (assume $20 average 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.

Subsidiary's Earnings per Share

Basic EPS	$3.30	Computed:	($3,600[a] - $300[b]) ÷ 1,000[c]
Diluted EPS	$2.40	Computed:	$3,600[d] ÷ (1,000 + 100[e] + 400[f])

Consolidated Earnings per Share

Basic EPS	$1.31	Computed:	($10,000[g] + $3,120[h]) ÷ 10,000[i]
Diluted EPS	$1.27	Computed:	($10,000 + $2,160[j] + $48[k] + $480[l]) ÷ 10,00

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[a]Subsidiary's net income

[b]Dividends paid by subsidiary on convertible preferred stock

[c]Shares of subsidiary's common stock outstanding

[d]Subsidiary's income available to common stockholders ($3,300) increased by $300 preferred dividends from applying the if-converted method for convertible preferred stock

[e]Incremental shares from warrants from applying the treasury stock method, computed: [($20 – $10) ÷ $20] × 200

[f]Shares of subsidiary's common stock assumed outstanding from conversion of convertible preferred stock, computed: 200 convertible preferred shares × conversion factor of 2

[g]Parent's net income

[h]Portion of subsidiary's income to be included in consolidated basic EPS, computed: (900 × $3.30) + (100 × $1.50)

[i]Shares of parent's common stock outstanding

[j]Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: (900 ÷ 1,000) × (1,000 shares × $2.40 per share)

[k]Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: (40 ÷ 200) × (100 incremental shares × $2.40 per share)

[l]Parent's proportionate interest in subsidiary's earnings attributable to convertible preferred stock, computed: (100 ÷ 200) × (400 shares from conversion × $2.40 per share)

Illustration 8—Application of the Treasury Stock Method for Stock Appreciation Rights and Other Variable Stock Option Award Plans

157. The following examples illustrate the provisions in paragraphs 20-22 for computing the effect on diluted EPS of stock appreciation rights and other variable stock option or award plans when the service period is presumed to be the vesting period. The examples do not comprehend all possible combinations of circumstances. Amounts and quantities have been rounded for simplicity. The following examples are based on the examples in Appendix B of Interpretation 31, which is superseded by this Statement. Accordingly, the terminology and compensation cost is based on the guidance in Opinion 25 and related literature.

The provisions of the agreements are as follows:

Date of grant	January 1, 1999

Expiration date	December 31, 2008
Vesting	100% at the end of 2002
Number of shares under option	1,000
Option exercise price	$10 per share
Quoted market price at date of grant	$10 per share

- Stock appreciation rights are granted in tandem with stock options for market value appreciation in excess of the option price.
- Exercise of the rights cancels the options for an equal number of shares and vice versa.
- Share appreciation is payable in stock, cash, or a combination of stock and cash at the entity's election.

The facts assumed are as follows:

- There are no circumstances in these two examples that would overcome the presumption that the rights are payable in stock (refer to paragraph 29).
- The tax deduction for compensation will equal the compensation recognized for financial reporting purposes.
- The quoted market prices of common stock on December 31 of the years 1999–2004 were as follows:

1999	$11
2000	$12
2001	$15
2002	$14
2003	$15
2004	$18

Example 1

158. The following example illustrates the annual computation of incremental shares for the above-described stock appreciation right plan. A single annual computation is shown for simplicity in this and in the following example. Normally, a computation would be done monthly or quarterly.

		Compensation							Additional Shares for Diluted EPS		
Date	Market Price	Per Share[a]	Aggregate[b]	Percentage Accrued[c]	Compensation Accrued to Date	Measurable Compensation Attributed to Future Periods[d]	Amount to Be Paid by Employee	Assumed Proceeds	Shares Issuable[e]	Treasury Shares Assumed Repurchased[f]	Incremental Shares
12/31/99	$11	$1	$1,000	25%	$ 250	$ 750	—	$ 750	47	35	12
12/31/00	12	2	2,000	50	1,000	1,000	—	1,000	130	76	54
12/31/01	15	5	5,000	75	3,750	1,250	—	1,250	259	83	176
12/31/02	14	4	4,000	100	4,000	0	—	0	310[g]	43[g]	267[g]
12/31/03	15	5	5,000	100	5,000	0	—	0	310	0	310
12/31/04	18	8	8,000	100	8,000	0	—	0	394	0	394

[a]Market price less exercise price ($10).

[b]Aggregate compensation for unexercised shares to be allocated to periods in which service is performed (shares under option × compensation per share).

[c]The percentage accrued is based on the four-year vesting period.

[d]Unaccrued compensation in this example.

[e]Average aggregate compensation ÷ average market price.

[f]Average assumed proceeds ÷ average market price.

[g]Illustration of computation of additional shares for one year (2002) follows:

Date	Market Price	Aggregate Compensation	Assumed Proceeds
12/31/01	$15.00	$5,000	$1,250
12/31/02	14.00	4,000	0
Average	14.50	4,500	625

Additional shares for diluted EPS:

Shares issuable	310	(4,500 ÷ $14.50)
Treasury shares	(43)	(625 ÷ $14.50)
Incremental shares	267	

Example 2

159. If the stock appreciation rights vested 25 percent per year commencing in 1999, the annual computation of incremental shares for diluted EPS in Example 1 would change as illustrated in the following example. The computation of compensation expense is explained in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans,* Appendix B, Example 2.

The additional facts assumed are as follows:

- On December 31, 2001, the employee exercises the right to receive share appreciation on 300 shares.
- On March 15, 2002, the employee exercises the right to receive share appreciation on 100 shares; quoted market price $15 per share.
- On June 15, 2003, the employee exercises the right to receive share appreciation on 100 shares; quoted market price $16 per share.
- On December 31, 2003, the employee exercises the right to receive share appreciation on 300 shares.
- On December 31, 2004, the employee exercises the right to receive share appreciation on 200 shares.

				Compensation							Additional Shares for Diluted EPS				
Date	Transaction	Number of Shares under Option	Market Price	Per Share[a]	Aggregate[b]	Percentage Accrued[c]	Compensation Accrued to Date	Measurable Compensation Attributed to Future Periods[d]	Amount to Be Paid by Employee	Assumed Proceeds	Shares Issuable[c]	Treasury Shares Assumed Repurchased[f]	Incremental Shares	Weighted-Average Shares Outstanding[g]	Total Shares
12/31/99			$11	$1	$1,000	52%	$ 520	$480	—	$480	47	22	25	—	25
12/31/00			12	2	2,000	79	1,580	420	—	420	130	39	91	—	91
12/31/01			15	5	5,000	94	4,700	300	—	300	259	26	233	—	233
12/31/01	SAR	300	15	5											
3/15/01	SAR	100	15	5											
12/31/02			14	4	2,400	100	2,400	0	—	0	193	10	183	126	309
6/15/03	SAR	100	16	6											
12/31/03			15	5	2,500	100	2,500	0	—	0	170[h]	0	170	153[i]	323
12/31/03	SAR	300	15	5											
12/31/04			18	8	1,600	100	1,600	0	—	0	78	0	78	270	348
12/31/04	SAR	200	18	8											

Transaction code:
SAR-Exercise of a stock appreciation right.

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[a]Market price for the year less exercise price ($10).

[b]Aggregate compensation for unexercised shares to be allocated to periods in which the service is performed (shares under option × compensation per share).

[c]Refer to the schedule in paragraph 24 of Interpretation 28.

[d]Unaccrued compensation in this example.

[e]Average aggregate compensation ÷ average market price, weighted for portion of period during which rights were unexercised.

[f]Average assumed proceeds ÷ average market price.

[g]Shares issued upon exercise of stock appreciation rights. These would be included in the enterprise's total weighted-average shares outstanding.

[h]Illustration of computation of shares issuable for one year (2003) follows:

	Number of Shares under Option	Compensation per Share	Aggregate Compensation	Market Price	Aggregate Shares Issuable	Weighing Factor	Shares Issuable
Rights outstanding:							
Entire year 2003	500	$4.50	$2,250	$14.50	155	12/12	155
1/1–6/15	100	5.00	500	15.00	33	5.5/12	15
							170

[i]Illustration of computation of weighted-average shares outstanding for one year (2003) follows:

	Number of Shares under Option	Compensation per Share	Aggregate Compensation	Market Price	Aggregate Shares Outstanding	Weighing Factor	Weighted-Average Shares Outstanding
Shares issued:							
12/31/01	300	$5	$1,500	$15	100	12/12	100
3/15/02	100	5	500	15	33	12/12	33
6/15/03	100	6	600	16	38	6.5/12	20
							153

Appendix D: AMENDMENTS TO EXISTING PRONOUNCEMENTS

160. This Statement supersedes the following pronouncements:

a. APB Opinion No. 15, *Earnings per Share*
b. AICPA Accounting Interpretations 1-102 of Opinion 15
c. AICPA Accounting Interpretations 1, "Changing EPS Denominator for Retroactive Adjustment to Prior Period," and 2, "EPS for 'Catch-up' Adjustment," of APB Opinion No. 20, *Accounting Changes*
d. FASB Statement No. 85, *Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent*
e. FASB Interpretation No. 31, *Treatment of Stock Compensation Plans in EPS Computations*.

161. This Statement also amends other pronouncements issued by either the Accounting Principles Board or the Financial Accounting Standards Board that refer to Opinion 15. All such references appearing in paragraphs that establish standards or the scope of a pronouncement are hereby amended to refer instead to FASB Statement No. 128, *Earnings per Share.*

162. The last sentence of paragraph 18 and footnote 8 of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* are replaced by the following:

> An investor's *share of the earnings or losses* of an investee should be based on the shares of *common* stock held by an investor.[8]
>
> ---
>
> [8]Paragraph 62 of FASB Statement No. 128, *Earnings per Share,* discusses the treatment of common shares or potential common shares for purposes of computing consolidated EPS. The provisions of that paragraph also apply to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

163. Opinion 20 is amended as follows:

a. The last sentence of paragraph 20 is replaced by the following:

> Presentation of per-share amounts for the cumulative effect of an accounting change shall be made either on the face of the income statement or in the related notes.

b. The parenthetical phrase in the second sentence of paragraph 21 is replaced by the following:

> (basic and diluted, as appropriate under FASB Statement No. 128*, Earnings per Share*)

c. In paragraphs 42 and 46, *(which are not common stock equivalents)* is deleted.

d. In the comparative statements in paragraphs 43, 44, and 47, in Note A in paragraph 47, and in the five-year summary in paragraph 48, *full* in *assuming full dilution* is deleted.

164. Paragraph 30(b) of APB Opinion No. 28, *Interim Financial Reporting,* is replaced by the following:

> Basic and diluted earnings per share data for each period presented, determined in accordance with the provisions of FASB Statement No. 128, *Earnings per Share*.

165. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* is amended as follows:

a. Paragraph 9 is amended as follows:

   (1) In the first sentence, *APB Opinion No. 15,* is replaced by *FASB Statement No. 128, Earnings per Share.*

   (2) Footnote 3 is deleted.

b. Paragraph 12 is replaced by the following:

> Earnings per share data for extraordinary items shall be presented either on the face of the income statement or in the related notes, as prescribed by Statement 128.

166. FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises,* is amended as follows:

a. Paragraph 12 is amended as follows:

   (1) In the first sentence, *APB Opinion No. 15*[3] *and* is deleted.

   (2) In the second sentence, *Opinion No. 15 and* is deleted.

   (3) Footnote 3 is deleted.

b. In paragraph 14, *earnings per share and* and *APB Opinion No. 15 and* are deleted.

167. FASB Statement No. 123, *Accounting for Stock-Based Compensation,* is amended as follows:

a. Paragraph 49 is replaced by the following:

> FASB Statement No. 128, *Earnings per Share,* requires that employee stock options, nonvested stock, and similar equity instruments granted to employees be treated as potential common shares in computing diluted earnings per share. Diluted earnings per share shall be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting is contingent upon factors other than continued service, such as the level of future earnings, the shares or options shall be treated as contingently issuable shares in accordance with paragraphs 30-35 of Statement 128. If stock options or other equity instruments are granted during a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding.

b. Paragraph 50 is amended as follows:

(1) In the first sentence, *Opinion 15* is replaced by *Statement 128.*

(2) In the second sentence, *FASB Interpretation No. 31, Treatment of Stock Compensation Plans in EPS Computations,* is replaced by *Statement 128.*

(3) In the third sentence, *Interpretation 31* is replaced by *Statement 128*.

c. Paragraph 357 is amended as follows:

(1) In the second sentence, *Under Opinion 15 and FASB Interpretation No. 31, Treatment of Stock Compensation Plans in EPS Computations* is replaced by *Under FASB Statement No. 128, Earnings per Share* and *common stock equivalents* is replaced by *potential common shares.*

(2) In the third sentence, *common stock equivalents* is replaced by *potential common shares.*

d. Paragraph 358 is amended as follows:

(1) The first three sentences are deleted.

(2) In the fourth sentence, *, of which 4,500,000 are expected to vest* is deleted.

(3) The seventh sentence is deleted.

e. Paragraph 359 and footnote 26 are replaced by the following:

Computation of assumed proceeds for diluted earnings per share:

• Amount employees would pay if all options outstanding were exercised using the weighted-average exercise price (4,600,000 x $40)	$184,000,000
• Average unrecognized compensation balance during year[26]	17,700,000
Assumed proceeds	$201,700,000

[26]Average unrecognized compensation balance is determined by averaging the beginning-of-the -year balance of cost measured and unrecognized and the end-of-the-year balance of cost measured and unrecognized. The assumed amount is $17,700,000 based on ongoing cost recognition for stock options granted inthe current year and prior years.

f. Paragraph 360 is replaced by the following:

Assumed repurchase of shares:

• Repurchase shares at average market price during the year ($201,700,000 ÷ $52)	3,878,846
• Incremental shares to be added (4,600,000 – 3,878,846)	721,154

The number of shares to be added to outstanding shares for purposes of the diluted earnings per share calculation is 721,154.

g. Paragraph 361 is deleted.

168. Paragraph 6 of FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans,* is replaced by the following:

> Stock appreciation rights and other variable plan awards are included in the computation of diluted earnings per share pursuant to the provisions of paragraphs 20-23 of FASB Statement No. 128, *Earnings per Share*.

169. Paragraph 7 of FASB Interpretation No. 38, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock,* is replaced by the following:

> Paragraphs 20-23 of FASB Statement No. 128, *Earnings per Share,* provide guidance on when and how junior stock plans should be reflected in the diluted earnings per share computation.

170. In the first sentence of paragraph 2 of FASB Technical Bulletin No. 79-8, *Applicability of FASB Statements 21 and 33 to Certain Brokers and Dealers in Securities, and APB Opinion No. 15, Earnings per Share,* is deleted.

Appendix E: GLOSSARY

171. This appendix contains definitions of certain terms or phrases used in this Statement.

Antidilution (antidilutive)
An increase in earnings per share amounts or a decrease in loss per share amounts.

Basic earnings per share (basic EPS)
The amount of earnings for the period available to each share of common stock outstanding during the reporting period.

Call option
A contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period. Refer to **option** and **purchased call option**.

Common stock (common shares)
A stock that is subordinate to all other stock of the issuer.

Contingent issuance
A possible issuance of shares of common stock that is dependent on the satisfaction of certain conditions.

Contingent stock agreement
An agreement to issue common stock (usually in connection with a business combination accounted for by the purchase method) that is dependent on the satisfaction of certain conditions. Refer to **contingently issuable shares**.

Contingently issuable shares (contingently issuable stock)
Shares issuable for little or no cash consideration upon the satisfaction of certain conditions pursuant to a contingent stock agreement. Refer to **contingent stock agreement**.

Conversion rate (conversion ratio)
The ratio of the number of common shares issuable upon conversion to a unit of a convertible security. For example, $100 face value of debt convertible into 5 shares of

common stock would have a conversion ratio of 5 to 1.

Convertible security

A security that is convertible into another security based on a conversion rate; for example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

Diluted earnings per share (diluted EPS)

The amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period.

Dilution (dilutive)

A reduction in earnings per share resulting from the assumption that convertible securities were converted, that options or warrants were exercised, or that other shares were issued upon the satisfaction of certain conditions.

Earnings per share (EPS)

The amount of earnings attributable to each share of common stock. For convenience, the term is used in this Statement to refer to either earnings or loss per share.

Exercise price

The amount that must be paid for a share of common stock upon exercise of an option or warrant.

If-converted method

A method of computing EPS data that assumes conversion of convertible securities at the beginning of the reporting period (or at time of issuance, if later).

Income available to common stockholders

Income (or loss) from continuing operations or net income (or net loss) adjusted for preferred stock dividends.

Option

Unless otherwise stated in this Statement, a call option that gives the holder the right to purchase shares of common stock from the reporting entity in accordance with an agreement upon payment of a specified amount. As used in this Statement, options include, but are not limited to, options granted to employees and stock purchase agreements entered into with employees. Options are considered "securities" in this Statement. Refer to **call option.**

Potential common stock

A security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period.

Preferred stock

A security that has rights that are preferential to common stock.

Purchased call option

A contract that allows the reporting entity to buy a specified quantity of its own stock from the writer of the contract at a fixed price for a given period. Refer to **call option**.

Put option

A contract that allows the holder to sell a specified quantity of stock to the writer of the contract at a fixed price during a given period.

Reverse treasury stock method

A method of recognizing the dilutive effect on 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 market price during the period. Refer to **put option.**

Rights issue

An offer to existing shareholders to purchase additional shares of common stock in accordance with an agreement for a specified amount (which is generally substantially less than the fair value of the shares) for a given period.

Security

The evidence of debt or ownership or a related right. For purposes of this Statement, it includes options and warrants as well as debt and stock.

Treasury stock method

A method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds would be used to purchase common stock at the average market price during the period.

Warrant

A security that gives the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount.

Weighted-average number of common shares outstanding

The number of shares determined by relating (a) the portion of time within a reporting period that common shares have been outstanding to (b) the total time in that period. In computing diluted EPS, equivalent common shares are considered for all dilutive potential common shares.

Appendix F: OTHER LITERATURE ON EARNINGS PER SHARE

172. The following table addresses changes to or continuation of other authoritative guidance on earnings per share, including that of the SEC and the EITF. For each item, this table either discusses the impact of this Statement, if any, or indicates reasons that specific items are beyond the scope of this Statement. This table is presented in this Statement for use as a reference tool. The Board did not deliberate any of the issues contained in the literature listed in this table, except where specifically noted.

Note: Current SEC, EITF, and AICPA guidance has been quoted, paraphrased, or restated to facilitate the reader's understanding of the effect of this Statement.

Status Legend:

Affirmed = Consensus is carried forward (with or without modifications).
N/A = Issue is either outside the scope of or unaffected by Statement 128.
Nullified = Consensus is overturned (either entirely or partially, as noted).
Pending = The SEC staff has indicated that it will consider amending or rescinding the guidance prior to the effective date of Statement 128.
Resolved = Guidance is provided by Statement 128 on issues previously unresolved by EITF.

Bold numbers in brackets refer to related paragraphs in Statement 128.

Status after Statement 128	Current Guidance	Effect of Statement 128
	Staff Accounting Bulletin (SAB) 64 Topic 3C: Redeemable Preferred Stock	
N/A	SAB 64 states that if the initial fair value of redeemable preferred stock is less than the mandatory redemption amount, the carrying amount of the stock should be increased to the mandatory redemption amount through periodic accretions charged against retained earnings. Those periodic accretions are treated in the same manner as a dividend on nonredeemable preferred stock for EPS computations. That is, dividends on the preferred stock and accretions of their carrying amounts cause income or loss available to common stockholders (the EPS numerator) to be less than reported income.	The Board expects to address the accounting for preferred stock in its project on distinguishing between liability and equity instruments. Statement 128 does not address numerator issues relating to the EPS computation. Statement 128 permits an adjustment only for preferred dividends in computing income available to common stockholders. The SEC guidance for redeemable preferred stock continues to apply. **[9]**
	Topic 6B: Accounting Series Release (ASR) No. 280–*General Revision of Regulation S-X*	
N/A	ASR 280 states that income or loss available to common stockholders should be reported on the face of the income statement when it is materially different in quantitative terms from reported net income or loss or when it is indicative of significant trends or other qualitative considerations.	The disclosure requirement is due, in part, to the provisions in Topic 3C; similar provisions are not included in Statement 128. Statement 128 does not require income available to common stockholders to be presented on the face of the income statement. The SEC disclosure guidance continues to apply.

SAB 68
Topic 5Q: Increasing Rate Preferred Stock

N/A	SAB 68 states that the discount resulting from the issuance of increasing rate preferred stock should be amortized over the period preceding commencement of the perpetual dividend through a charge to retained earnings and a corresponding increase in the carrying amount of the preferred stock. Those periodic increases are treated in the same manner as a dividend on nonredeemable preferred stock for EPS computations. That is, dividends on the preferred stock and accretions of their carrying amounts cause income or loss available to common stockholders (the EPS numerator) to be less than reported income.	The Board expects to address the accounting for preferred stock in its project on distinguishing between liability and equity instruments. Statement 128 does not address numerator issues relating to the EPS computation. Statement 128 permits an adjustment only for preferred dividends in computing income available to common stockholders. The SEC guidance for increasing rate preferred stock continues to apply. **[9]**

SAB 83
Topic 4D: Earnings per Share Computations in an Initial Public Offering

Pending	The guidance in SAB 83 is applicable to registration statements filed in connection with an initial public offering (IPO) of common stock. SAB 83 states that potentially dilutive instruments with exercise prices below the IPO price that are issued within a one-year period prior to the initial filing of the IPO registration statement should be treated as outstanding for all reported periods (current and prior), in the same manner as shares issued in a stock split are treated. However, in determining the dilutive effect of the issuances, a treasury stock approach may be used.	Statement 128 would permit those potentially dilutive common shares to be included only in the computation of *diluted* EPS and only from the date of issuance. In essence, SAB 83 permits an entity involved in an IPO to treat those potentially dilutive common shares as outstanding common shares in the computation of both basic and diluted EPS for all reported periods. **[17]**

	This method should be applied in the computation of EPS for all prior periods, including loss years in which the impact of the incremental shares is antidilutive.	Statement 128 does not permit incremental shares to be included in the computation of diluted EPS when an entity has a loss from continuing operations (as the effect is antidilutive). **[13, 15, 16]** The SEC guidance continues to apply to SEC registrants involved in an IPO that have issued such potentially dilutive common shares.
	EITF Topic No. D-15—Earnings-per-Share Presentation for Securities Not Specifically Covered by APB Opinion No. 15	
N/A	Topic D-15 (an SEC Observer announcement) states that when situations not expressly covered in Opinion 15 occur, they should be dealt with according to their substance. It also provides the two following general principles that must be considered in analyzing new securities in order to reflect the most appropriate EPS presentation.	Although not expressly stated, this broad concept is implicit in Statement 128.
Pending	1. Securities that enable the holder to participate with common shareholders in dividends over a significant period of time should be reflected in EPS using the two-class method if that method is more dilutive than other methods.	Statement 128 requires use of the two-class method for participating securities that are not convertible into common stock (the if-converted method should be used for all convertible securities). **[60, 61]**
Pending	2. Contingent issuances should be reflected in fully diluted EPS if those contingent issuances have at least a reasonable possibility of occurring.	The contingent-share provisions in Statement 128 are fairly specific and do not permit an entity to consider the probability of a contingent issuance occurring. **[30]**

EITF Topic No. D-42—The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock

N/A	Topic D-42 (an SEC Observer announcement) states that if a registrant redeems its preferred stock, the excess of the fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock should be subtracted from net income to arrive at net income available to common stockholders in the computation of EPS. Similarly, if convertible preferred stock is converted to other securities issued by the registrant pursuant to an inducement offer, the excess of the fair value of all securities and other consideration transferred to the holders of the convertible preferred stock over the fair value of securities issuable pursuant to the original conversion terms should be subtracted from net income to arrive at net income available to common stockholders.	The Board expects to address the accounting for preferred stock in its project on distinguishing between liability and equity instruments. Statement 128 does not address numerator issues relating to the EPS computation. Statement 128 permits an adjustment only for preferred dividends in computing income available to common stockholders. The SEC guidance for redemption or induced conversion of preferred stock continues to apply. **[9]**

EITF Topic No. D-53—Computation of Earnings per Share for a Period That Includes a Redemption or an Induced Conversion of a Portion of a Class of Preferred Stock

N/A	Topic D-53 (an SEC Observer announcement) is related to Topic D-42. Topic D-53 states that if a registrant effects a redemption or induced conversion of only a *portion* of the outstanding securities of a class of preferred stock, any excess consideration should be attributed to those shares that are redeemed or converted.	The Board expects to address the accounting for preferred stock in its project on distinguishing between liability and equity instruments. Statement 128 does not address numerator issues relating to the EPS computation. The SEC guidance for redemption or induced conversion of preferred stock continues to apply.
	For purposes of determining whether the "if converted" method is dilutive for the period, the shares redeemed or converted should be considered separately from those shares that are not redeemed or converted.	The "if converted" provisions in Statement 128 do not address how to determine whether a convertible security is antidilutive when there has been a partial conversion. **[26-28]**
	EITF Issue No. 85-18—Earnings-per-Share Effect of Equity Commitment Notes	
Nullified	Issue 85-18 states that shares contingently issuable under equity commitment notes and equity contracts should *not* be included in EPS computations. Those shares are considered contingently issuable because the company has an option of paying in cash or stock.	Statement 128 contradicts the consensus reached. Statement 128 states that contracts that may be settled in stock or cash should be presumed to be settled in stock and reflected in the computation of diluted EPS unless past experience or a stated policy provides a reasonable basis to believe otherwise. **[29]**
Affirmed	Issue 85-18 states that equity contracts that specifically require the issuance of common stock to repay debt should be included in the EPS computations as potentially dilutive securities.	Statement 128 supports the consensus reached; equity contracts that require payment in stock should be considered potentially dilutive securities (convertible debt). **[26-28]**
	EITF Issue No. 87-31—Sale of Put Options on Issuer's Stock	

Affirmed	Issue 87-31 prescribes use of the reverse treasury stock method to account for the dilutive effect of written put options that are "in the money" during the period.	In computing diluted EPS, Statement 128 requires use of the reverse treasury stock method to account for the dilutive effect of written put options and similar contracts that are "in the money" during the reporting period. **[24]**
	Note: The EITF combined the consensuses in this Issue with the consensuses in Issue No. 96-13, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."	
	EITF Issue No. 88-9—Put Warrants	
N/A	The EITF superseded its consensus on this Issue for companies with publicly traded stock in Issue 96-13.	**N/A**
	EITF Issue No. 90-4—Earnings-per-Share Treatment of Tax Benefits for Dividends on Stock Held by an Employee Stock Ownership Plan (ESOP)	
Nullified	Issue 1: Dividends on preferred stock held by an ESOP should be deducted from net income, net of any applicable income tax benefit, when computing primary EPS.	Statement 128 has no provisions related to primary EPS and, thus, nullifies the consensus of Issue 90-4. However, it seems appropriate to make a similar deduction for dividends on preferred stock held by an ESOP when computing both basic and diluted EPS if that preferred stock is considered outstanding (that is, if the ESOP shares are allocated).

Issue 2: The second issue was addressed by the EITF in Issue No. 92-3, "Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan (Consideration of the Implications of FASB Statement No. 109 on Issue 2 of EITF Issue No. 90-4)."

EITF Issue No. 90-19—Convertible Bonds with Issuer Option to Settle for Cash upon Conversion

Issue 90-19 provides EPS guidance for companies that issue debt instruments that are convertible into a fixed number of common shares. Upon conversion, the issuer either is required or has the option to satisfy all or part of the obligation in cash as follows:

Affirmed *	Instrument A: If the issuer must satisfy the obligation entirely in cash, the instrument does not have an impact on primary or fully diluted EPS other than that the conversion spread must be recognized as a charge to income.	Statement 128 implicitly supports the consensus reached; this type of security does not meet the definition of potential common stock. **[171]**
Affirmed *	Instrument B: If the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value, the instrument is treated as convertible debt for purposes of computing primary and fully diluted EPS.	Statement 128 implicitly supports the consensus reached. Contracts that may be settled in stock or cash should be presumed to be settled in stock and reflected in the computation of diluted EPS unless past experience or a stated policy provides a reasonable basis to believe otherwise. **[29]**

Affirmed *	Instrument C: If the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread in either cash or stock, the instrument does not have an impact on primary EPS but impacts fully diluted EPS as convertible debt.	Statement 128 implicitly supports the consensus reached for diluted EPS. **[29]**
	EITF Issue No. 92-3—Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan (Consideration of the Implications of FASB Statement No. 109 on Issue 2 of EITF Issue No. 90-4)	
N/A	Issue 92-3 states that tax benefits related to dividends paid on unallocated common stock held by an ESOP, which are charged to retained earnings, should not be an adjustment to net income for purposes of computing EPS.	Statement 128 provides no guidance on common stock held by an ESOP. The guidance in AICPA Statement of Position (SOP) 93-6, *Employers' Accounting for Employee Stock Ownership Plans,* continues to apply as does the consensus in EITF Issue 92-3. AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans,* continues to apply for "grandfathered" shares.
	SOP 93-6 was issued in November 1993. Under SOP 93-6, dividends paid on unallocated ESOP shares are not treated as dividends for financial reporting purposes and, therefore, do not affect the if-converted EPS computations.	
	EITF Issue No. 94-7—Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock	

Resolved	Issue 94-7 addresses the classification of certain contracts (forward sales, forward purchases, purchased put options, and purchased call options) that are settled in a variety of ways (physical, net share, or net cash) as equity instruments or assets-liabilities and specifies the treatment of changes in the fair value of those instruments. The Issue does not address EPS treatment.	Statement 128 states that contracts that may be settled in stock or cash should be presumed to be settled in stock and reflected in the computation of diluted EPS unless past experience or a stated policy provides a reasonable basis to believe otherwise. **[29]**
	Note: The EITF combined the consensuses in this Issue with the consensuses in Issue 96-13.	In computing diluted EPS, Statement 128 requires use of the reverse treasury stock method to account for the dilutive effect of written put options and similar contracts that are "in the money" during the reporting period. Statement 128 states that purchased options should not be reflected in the computation of diluted ESP because to do so would be antidilutive. **[24, 25]**
	EITF Issue No. 96-1—Sale of Put Options on Issuer's Stock That Require or Permit Cash Settlement	
Resolved	Issue 96-1 provides guidance similar to Issue 94-7 and relates only to written put options settled in a variety of ways. The Issue does not address EPS treatment.	Refer to discussion on Issue 94-7.
	Note: The EITF combined the consensuses in this Issue with the consensuses in Issue 96-13.	

	EITF Issue No. 96-13—Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock	
Resolved	Issue 96-13 codifies the consensuses provided in Issues 87-31,94-7, and96-1 into a framework that can be applied to a variety of similar financial instruments settled in a variety of different ways. With the exception of the consensus on use of the reverse treasury stock method in Issue 87-31, Issue 96-13 does not address EPS treatment.	Refer to discussion on Issue 94-7.

Footnotes

FAS128, Footnote 1--Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

FAS128, Footnote 2--That is, investment companies that comply with the requirements of the AICPA Audit and Accounting Guide, *Audits of Investment Companies*, to present selected per-share data.

FAS128, Footnote 3--Preferred dividends that are cumulative only if earned shall be deducted only to the extent that they are earned.

FAS128, Footnote 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.

FAS128, Footnote 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.

FAS128, Footnote 6--Options and warrants generally will be included first because use of the treasury stock method does not impact the numerator of the computation.

FAS128, Footnote 7--Refer to footnote 4.

FAS128, Footnote 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.

FAS128, Footnote 9--Refer to paragraph 64.

FAS128, Footnote 10--Refer to paragraphs 21, 47, and 48.

FAS128, Footnote 11--Consider Corporation Y that has 10,000 warrants outstanding exercisable at $54 per share; the average market price of the common stock during the reporting period is $60. Exercise of the warrants and issuance of 10,000 shares of common stock would be assumed. The $540,000 that would be realized from exercise of the warrants ($54 × 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 = [(market price – exercise price)/market price] × shares assumed issued under option; thus, [($60 – $54)/$60] × 10,000 = 1,000 incremental shares.

FAS128, Footnote 12--The provisions in paragraphs 20-23 also apply to stock-based awards issued to other than employees in exchange for goods and services.

FAS128, Footnote 13--This provision applies only to those stock-based awards for which compensation cost will be recognized in the financial statements in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*, or Statement 123.

FAS128, Footnote 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.

FAS128, Footnote 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.

FAS128, Footnote 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.

FAS128, Footnote 17--An example of such a contract is a written put option that gives the holder a choice of settling in common stock or in cash. Stock-based compensation arrangements that are payable in common stock or in cash at the election of either the entity or the employee shall be accounted for pursuant to this paragraph.

FAS128, Footnote 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.

FAS128, Footnote 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.

FAS128, Footnote 20--Refer to footnote 4.

FAS128, Footnote 21--Paragraph 33 of FASB Statement No. 95, *Statement of Cash Flows,* prohibits reporting an amount of cash flow per share.

FAS128, Footnote 22--Refer to footnote 4.

FAS128, Footnote 23--An entity is encouraged to refer to pertinent information about securities included in the EPS computations that is provided elsewhere in the financial statements as prescribed by FASB Statement No. 129, *Disclosure of Information about Capital Structure*, and other accounting pronouncements.

FAS128, Appendix A, Footnote 24--Refer to ARB No. 43, Chapter 7B, "Capital Accounts—Stock Dividends and Stock Split-Ups."

FAS128, Appendix A, Footnote 25--Dividends declared in the current period do not include dividends declared in respect of prior-year unpaid cumulative dividends. Preferred dividends that are cumulative only if earned are deducted only to the extent that they are earned.

FAS128, Appendix A, Footnote 26--Refer to paragraphs 140 and 141.

FAS128, Appendix A, Footnote 27--Issuing common shares that are not fully paid is permitted in some countries.

FAS128, Appendix B, Footnote 28--FASB *Highlights,* “FASB’s Plan for International Activities,” January 1995.

FAS128, Appendix B, Footnote 29--The method is described in Graham, Dodd, and Cottle, *Security Analysis: Principles and Technique,* 4th ed. (New York: McGraw-Hill, 1962).

FAS128, Appendix B, Footnote 30--Statement 123 generally requires that valuation only at the grant date.

FAS128, Appendix F, Footnote *--The guidance related to primary EPS is nullified because Statement 128 eliminates the presentation of primary EPS.