

August 13, 2008
Vol. 15, Issue 32

In This Issue:

- Fair Value Method
- Basic EPS
- Diluted EPS
- Effective Date and Transition

*The amendments
range from changes
to the treasury
stock method to the
creation of the fair
value method.*

A Common Denominator

FASB and IASB Issue Exposure Documents on Earnings per Share

by John Sarno, Magnus Orrell, and Rob Comerford, Deloitte & Touche LLP

Late last week the FASB issued an [Exposure Draft](#) proposing amendments to FASB Statement No. 128, *Earnings per Share*. Simultaneously, the IASB issued a parallel [proposal](#) to amend IAS 33, *Earnings per Share*. The comment period for both documents ends on December 5, 2008.

The proposed amendments reflect the boards' efforts to converge the guidance on earnings per share (EPS) in U.S. GAAP and International Financial Reporting Standards (IFRSs) as well as to clarify and simplify this guidance. Since other accounting differences between U.S. GAAP and IFRSs rule out the possibility of achieving a common numerator (i.e., earnings) in EPS calculations, the boards instead focused their proposed amendments on achieving a common denominator (i.e., number of shares).

Think the changes won't affect your entity? Think again. The amendments range from changes to the treasury stock method to the creation of the so-called "fair value method." So if you're a public entity or an entity that otherwise provides EPS information, please read on.

Fair Value Method

Before we outline the specifics of the EPS proposals, a brief discussion of the fair value method is warranted. While it is **not** another means of computing EPS (e.g., unlike the treasury stock and if-converted methods), the fair value method serves as shorthand for a proposal to **exclude** some instruments from the computation of EPS. That is, other than the changes in fair value recorded in net income or earnings available to common shareholders (i.e., the numerator of EPS), the exposure documents propose to exclude from the computation of diluted EPS the dilutive effect that would be caused by the exercise or conversion of instruments¹ that are measured at fair value with changes in fair value recognized in earnings each reporting period. In addition, the exposure documents propose to exclude participating securities measured at fair value, with changes in fair value recognized in earnings each reporting period, from the application of the two-class method. The boards reasoned that the changes in fair value recognized in earnings (and hence affecting the numerator) are a better reflection of the benefits received or the detriments incurred by the current shareholders during the period than any of the existing methods to capture dilution (each of which primarily focuses on the number of shares included in the denominator of EPS). Therefore, rather than requiring the treasury stock, the if-converted, or the two-class method to be performed in the computation of the number of additional shares that would be issued upon exercise or conversion of such instruments (or

¹ Including components of compound instruments that are accounted for as if they were freestanding.

components), the boards decided to exclude such instruments from the computation of EPS other than for their changes in fair value recorded in net income or earnings available to common shareholders (i.e., the numerator of EPS).

What exactly are the practical implications of this change? For one thing, an instrument such as an outstanding call option or warrant contract that is settled in the issuer's shares, but is classified as a derivative liability because of the requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, would no longer affect the denominator in the computation of diluted EPS under the treasury stock method. Instead, the fair value adjustments recorded in net income each reporting period would affect the numerator. Alternatively, if an entity elected the fair value option for its convertible debt instruments, the convertible debt instrument would no longer affect the denominator in the computation of diluted EPS using the if-converted method. Instead, the only impact on EPS would be the fair value adjustments recorded in net income each reporting period. Finally, note that the proposal also affects share-based payment awards. If such an award can be settled in shares, is classified as a liability, and is remeasured at a fair-value-based amount each reporting period (or capitalized as part of the cost of an asset and recognized in earnings in a subsequent period), that award also would be excluded from the computation of diluted EPS other than for the fair-value-based adjustment recorded as compensation cost in net income each reporting period.

Let's now discuss the FASB's proposed changes to the computation of both basic and diluted EPS.

The exposure document proposes to more clearly articulate the instruments that are included in the computation of basic EPS.

Basic EPS

The FASB's exposure document proposes to more clearly articulate the instruments that are included in the computation of basic EPS. Those instruments are:

1. Outstanding common shares (including common shares with different dividend rights).
2. Instruments that are currently exercisable or shares that are "currently issuable for little or no cost to the holder."²
3. Participating securities that are "not measured at fair value with changes in fair value recognized in current period earnings."

The FASB is essentially saying that in the computation of basic EPS, an entity should only include (1) the current shareholders, (2) instruments that can currently become common shares without much sacrifice on the part of the holder, or (3) instruments that can currently participate in earnings with the common shareholders.

This clarification also indicates a change in the position taken by the FASB in an earlier exposure draft on EPS. According to the proposal, mandatorily convertible instruments are not included in the computation of basic EPS before the instruments are converted into common shares unless the holders of the instrument (in the instrument's current form) could participate in current-period earnings with common shareholders. Said differently, before conversion the mandatorily convertible instrument holder is not a common shareholder. Therefore, unless the instrument participates in current-period earnings with the common shareholders (i.e., is a participating security), it would not be included in the computation of basic EPS. If the instrument is considered a participating security, then the instrument would be included in the computation of basic EPS using the two-class method.³

² The proposal goes on to say that "little or no cost" refers "to the amount required to be paid by the holder, whether in the form of cash, other assets, or services rendered (such as employee services)." Therefore, an unvested share-based payment award with a nominal exercise price would **not** be included in the denominator of basic EPS because the employee has yet to provide the requisite service to pay for the award.

³ As described in paragraph 61 of Statement 128, 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."

In addition, as a housekeeping matter, the FASB's exposure document proposes to amend Statement 128 to clarify that a convertible participating security is included in the computation of basic EPS using the two-class method. This amendment effectively codifies in Statement 128 the consensus that was reached in Issue 7 of EITF Issue 03-6, "Participating Securities and the Two-Class Method Under FASB Statement No. 128."

Diluted EPS

Instruments That May Be Settled in Cash or Common Shares

Under the existing Statement 128, an instrument that can be settled in cash or shares is presumed to be settled in shares. That presumption may be overcome on the basis of an entity's past practice or stated policy of settling these types of instruments in cash. The FASB's exposure document proposes to remove the ability to overcome the presumption of share settlement. That is, the proposal requires an entity to assume that an instrument that can be settled in cash or shares **will be settled in shares**.

Editor's Note: An example of an instrument that can be settled in cash or shares is Instrument X.⁴ Because both the principal and the conversion spread can be settled in cash or shares, such an instrument would be included in the computation of diluted EPS using the if-converted method.

However, the FASB provided an exception for instruments that can **only** be share settled in the event of bankruptcy and will in all other cases be cash settled. An entity does not need to assume that such instruments will be share settled.

Editor's Note: An instrument that can be settled in cash or shares may be classified as a liability. If that instrument is classified as a liability and measured at fair value with changes in fair value recognized in earnings each reporting period, the fair value method discussed above would apply.

The proposal requires an entity to assume that an instrument that can be settled in cash or shares will be settled in shares.

Treasury Stock Method and Reverse Treasury Stock Method⁵

The exposure document proposes a couple of changes to the treasury stock method and the reverse treasury stock method (i.e., the methods used to capture the potentially dilutive impact of instruments such as outstanding call options and warrant contracts).

The first change is a proposal to move from using an **average** to an **end-of-period** market price of an entity's shares in the computation of the number of incremental shares to include in diluted EPS under both the treasury stock method and the reverse treasury stock method. Unlike existing requirements, the proposal requires the use of the end-of-period market price to determine the number of common shares that an entity could hypothetically (1) repurchase with the assumed proceeds from exercise of the contract under the treasury stock method and (2) sell to raise enough proceeds to satisfy the contract under the reverse treasury stock method. The number of incremental shares to be included in the denominator of diluted EPS is determined by comparing the number of shares hypothetically repurchased or sold with the number of shares that would be issued or purchased under the contract. The FASB reasoned that the market price of the entity's shares at the end of a period, rather than the average market price of an entity's shares, is a more relevant amount to use in determining the number of shares that could potentially dilute current shareholders as of the end of a reporting period.

⁴ As discussed in an SEC staff speech at the 2003 AICPA National Conference on Current SEC Developments, Instrument X provides the entity with the ability to settle the conversion value in any combination of cash or shares. For example, an entity may settle (1) the entire conversion value in cash or shares, (2) the principal in cash and the excess of the conversion value over the accreted amount in shares, or (3) the principal in shares and the excess of the conversion value over the accreted amount in cash.

⁵ The reverse treasury stock method is used to capture the potential dilutive impact of instruments such as written put options and certain forward purchase contracts.

The second change applies only in a fairly limited set of circumstances. The exposure document proposes to include the carrying amount of an instrument that is classified as a liability and that can be settled in common shares as a component of assumed proceeds under the treasury stock method. The FASB reasoned that if an entity extinguishes a liability without sacrificing its assets (e.g., cash or other assets) by issuing shares, the extinguishment has the same effect on an entity's net assets as issuing shares for cash to then settle the liability.

Editor's Note: As noted above in the discussion of the [fair value method](#), an instrument that can somehow be settled in common equity and is measured at fair value with changes in fair value recognized in earnings each reporting period is excluded from the computation of diluted EPS. Therefore, this change to the treasury stock method would only affect an instrument that can be settled in shares, is classified as a liability, and is measured at something other than fair value (e.g., intrinsic value or cost). Few instruments will meet all of these criteria. One example may be certain types of share-settled debt.

Quarterly and Year-to-Date Computations

The exposure document proposes that entities view each quarter and year-to-date period as a discrete period.

In computing year-to-date diluted EPS, an entity is **currently** required to weight incremental shares and shares issuable under a contingent stock agreement to be included in diluted EPS on the basis of the number of shares included in each quarter-to-date period. For example, assume that when applying the treasury stock method, an entity determined that it must include 10,000 and 15,000 incremental shares (using an average market price, as discussed above) in the denominator of diluted EPS for its first and second quarters, respectively. When computing the number of incremental shares to include in the denominator of diluted EPS for the year-to-date six-month period, the entity would weight the 10,000 and 15,000 incremental shares equally. Therefore, 12,500 incremental shares $[(10,000 + 15,000) \div 2]$ would be included in the denominator of diluted EPS for the year-to-date six-month period. That is, the entity would not perform an entirely new treasury stock computation to compute the number of incremental shares to include in the denominator of diluted EPS for the year-to-date six-month period using an average market price of the entity's shares for the six-month period.

In contrast, the exposure document **proposes** that entities view each quarter and year-to-date period as a discrete period. Accordingly, an entity would be required to separately compute the number of incremental shares (using end-of-period market prices) to be included in diluted EPS for each quarter and year-to-date period. For contingently issuable shares, entities would include the shares as of the beginning of the quarterly and year-to-date period in which the contingency was met. In the above example, instead of equally weighting the 10,000 and 15,000 incremental shares included in the denominator of diluted EPS for the first and second quarter, the entity would have to perform an entirely new treasury stock computation for the six-month period using the end-of-period market price at the end of the year-to-date period.

Participating Securities

The exposure document proposes guidance on the computation of diluted EPS when there is a participating security or second class of common stock with different dividend rates. Statement 128 includes an illustration of the calculation of basic EPS (see Illustration 6), but stops short of providing any guidance on the computation of diluted EPS. The FASB's exposure document includes three examples of the computation of diluted EPS when there are varying types of participating securities or a second class of common stock (see Illustration 6A).

According to the proposed guidance, the computation of diluted EPS for a participating security or a second class of common stock that also is a potential common share must reflect the more dilutive effect of applying (1) the two-class method, assuming the participating security or second class of common stock is not exercised or converted, or (2) the treasury stock, reverse treasury stock, if-converted, or contingently issuable share method for the participating security or the second class of common stock.⁶

Editor's Note: A participating security may be measured at fair value with changes in fair value recognized in earnings each reporting period. If so, that security would be **excluded** from the computation of basic and diluted EPS under the **fair value method** discussed above.

Effective Date and Transition

The FASB's exposure document does not include a specific effective date. Rather, the Board reasoned that the effective date should be set after the public has had an opportunity to comment on the document and the Board has begun redeliberations of the comments received. The comment period closes on December 5, 2008. Regardless of the effective date ultimately chosen, a final standard would be effective as of the beginning of an entity's annual period and interim periods within those annual periods. The proposal also indicates that early adoption of a final standard will be prohibited.

As is typical with new EPS guidance, the FASB's exposure document proposes to retrospectively apply the guidance to all prior-period EPS data (including interim financial statements, summary of earnings, and selected financial data). There is one exception. As discussed above, instruments that allow for a choice of settlement (i.e., in either cash or shares) are presumed to be settled in shares for the EPS calculation. That presumption may not be overcome. If an entity overcame the share-settlement presumption in a prior period, however, the entity does **not** have to retrospectively apply the guidance in this exposure document if the entity has (1) cash settled the instrument or (2) modified the instrument to remove the share settlement alternative before the last day of the period of adoption (including interim periods in the year of adoption).

Regardless of the effective date ultimately chosen, a final standard would be effective as of the beginning of an entity's annual period and interim periods within those annual periods.

⁶ Scenarios 2 and 3 of Illustration 6A in Appendix A of the exposure document provide specific examples of a second class of common shares that are convertible into the other class of common shares. Those examples would apply equally to participating securities that are convertible into common shares.

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Standards and Communications Group, please [register](http://www.deloitte.com/us/subscriptions) at www.deloitte.com/us/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts presented each month on:

- Risk intelligence.
- Corporate governance.
- Private companies.
- FAS 109.
- Financial reporting.
- Driving enterprise value.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. [Join *Dbriefs*](#) to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Registration is available now for these upcoming *Dbriefs* webcasts:

- [U.S. GAAP and IFRS Convergence: Bridging the Divide](#) (September 3).
- [EITF Roundup: Highlights of the September Meeting](#) (September 16).

Use the links above to register. The webcasts begin at 2 p.m. (EDT).

Technical Library: The Deloitte Accounting Research Tool

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. In addition, Technical Library subscribers receive *Technically Speaking*, the weekly publication that highlights recent additions to the library.

For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

Heads Up is prepared by the National Office Accounting Standards and Communications Group of Deloitte & Touche LLP ("Deloitte & Touche") as developments warrant. This publication contains general information only and Deloitte & Touche is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte & Touche, its affiliates and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.