PROPOSED FASB STAFF POSITION

No. FAS 128-a

Title: Computational Guidance for Computing Diluted EPS under the Two-Class Method

Comment Deadline: March 27, 2007

Introduction

1. This FASB Staff Position (FSP) provides computational guidance for diluted earnings per share (EPS) when applying the two-class method pursuant to FASB Statement No. 128, *Earnings per Share.*

Background

2. Paragraphs 60 and 61 of Statement 128 establish the guidance for including participating securities and two-class common stock (collectively referred to herein as participating securities) in the computation of earnings per share. Paragraph 61 provides that "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 EITF, in Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128," further clarified the definition of participating securities and reached a consensus (in Issue 7) that convertible participating securities should always be included in the computation of basic earnings per share using the two-class method. Additionally, in situations in which an entity has multiple classes of common stock, paragraph 61(d) of Statement 128 requires that "basic and diluted EPS data shall be presented for each class of common stock."

3. The existing literature provides clear examples of the application of the two-class method in computing **basic** EPS, but does not specifically address or illustrate the application of the two-class method in computing **diluted** EPS. As a result, questions have been raised about computing diluted EPS when an entity has common stock, participating securities, and potential common stock. Although Statement 128 has been effective since 1998, constituents have raised those questions because of, (a) the consensuses reached by the EITF in Issue 03-6, which expand the definition of a participating security and thereby increase use of the two-class method for

computing earnings per share, and (b) the recently proposed FSP EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities," that addresses whether instruments granted in share-based payment transactions may be participating securities prior to vesting and, therefore, need to be included in basic EPS using the two-class method.

FASB Staff Position

4. The staff believes that diluted EPS under the two-class method should be computed under the following three-step process:

Step 1: Compute basic EPS using the two-class method.

Step 2: Using total earnings allocated to the common stock under Step 1, compute diluted EPS (with earnings available/allocated to common shareholders as the numerator).

If the participating security is also a potential common share, then determine the dilutive effect under both of the following approaches:

a. Assume the instrument has been exercised, converted, or issued (that is, apply the treasury stock method, the if-converted method, or the contingently issuable share method). In addition, assume all other dilutive potential common shares have been exercised, converted, or issued, giving specific consideration to the antidilution sequencing provisions in Statement 128.
b. Add back the undistributed earnings allocated to the participating security (or securities) in arriving at basic EPS and assume all other dilutive potential common shares have been exercised, converted, or issued, giving specific consideration to the antidilution sequencing provisions of Statement 128. Then reallocate undistributed earnings to the common shares and the participating security (or securities) giving effect to any additional common shares (denominator) and any additional income (numerator) that would result from exercise, conversion or issuance of potential common shares (that is, the two-class method).

Determine the more dilutive effect of Step 2(a) or 2(b).

If the participating security is not a potential common share, then determine the dilutive effect using Step 2(b).

Step 3: Determine whether diluted EPS is required to be presented, in accordance with paragraph 61(d) of Statement 128, for a second class of common stock.[1] If so, compute diluted EPS for the second class of common stock using the two-class method assuming additional common shares of the first class of common stock are outstanding resulting from the conversion of all potential common shares outstanding. That is, determine the incremental effect of reallocating undistributed earnings to the second class of common stock. For a second class of common stock convertible into the first class of common stock, disclose the fact that (a) diluted EPS for the second class of common stock does not assume conversion into the first class of common stock and (b) diluted EPS for the first class of common stock assumes conversion of the second class of common stock into the first class of common stock, if dilutive.

5. To illustrate the application of the staff position to various scenarios, the staff has prepared illustrations that are included as an appendix to this FSP.

Effective Date and Transition

6. The provisions of this FSP will have the same effective date as proposed FSP EITF 03-6-a. All prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform to the provisions of this FSP.

[1] Paragraph 61(d) of Statement 128 states, "Basic and diluted EPS data shall be presented for each class of common stock."

Appendix

ILLUSTRATIONS OF THE APPLICATION OF THE STAFF POSITION

Scenario 1—Common Stock with Participating Preferred Security

A1. Assume that Company XYZ had 10,000 shares of common stock and 5,000 shares of nonconvertible preferred stock outstanding during 20X1 and net income of $65,000. The preferred stock is entitled to a noncumulative annual dividend of $5 per share. After the 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 the common stock. (That is, after the preferred and the common stock have been paid dividends of $5 and $2 per share, respectively, the preferred stock participates in any additional dividends at a rate of two-thirds of the additional amount paid to common stock on a per-share basis.)

A2. For 20X1, the preferred shareholders have been paid $27,000 (or $5.40 per share), and the common shareholders have been paid $26,000 (or $2.60 per share). On January 1, 20X1, Company XYZ issued 1,000 30-year convertible bonds with an aggregate par value of $1,000,000. Each bond is convertible into 8 shares of common stock and carries a coupon rate of 3 percent. Assume further that on January 1, 20X1, Company XYZ granted options to employees to purchase 2,000 shares of common stock at $50 per share and that the average market price of Company XYZ's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff-vesting). The Company expects all of the option awards to vest. Company XYZ's tax rate for 20X1 is 40 percent.

Step 1—Compute basic EPS for 20X1 using the two-class method

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

Allocation of undistributed earnings:

To preferred:
0.4(5,000) ÷ [.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) ÷ [.4(5,000) + 0.6(10,000)] × $12,000 = $9,000
$9,000 ÷ 10,000 shares = $0.90 per share

Basic EPS amounts:

	Preferred	Common
Distributed earnings	$5.40	$2.60
Undistributed earnings	0.60	0.90
Total	$6.00	$3.50

Step 2—Compute diluted EPS for the common stock

Antidilution Sequencing

	Increase in Earnings Available to Common Shareholders	Increase in Number of Common Shares	Earnings per Incremental Share
Options	—	121(a)	—
Convertible bonds	$18,000(b)	8,000(b)	$2.25

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:	
Exercise price	$50 × 2,000 = $100,000
Average unrecognized compensation cost	($10,000 + $7,500) ÷ 2 = $8,750
Excess tax benefit	{[($60 − $50) − $5] × 2,000} × 40% = $4,000
Shares repurchased	$112,750 ÷ $60 = 1,879
Incremental shares	2,000 − 1,879 = 121 shares

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

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

	Undistributed & Distributed Earnings to Common	Common Shares	Earnings per Share
As reported—Basic	$35,000(c)	10,000	$3.50
Add-back: Undistributed earnings allocated to preferred shares	3,000	—	
	38,000	10,000	3.80
Options*	—	121(a)	
	38,000	10,121	3.75
Convertible bonds*	18,000(b)	8,000(b)	
	56,000	18,121	3.09
Less: Undistributed earnings reallocated to preferred shares	(4,661)(d)	—	
Diluted EPS for common stock	**$51,339**	**18,121**	**$2.83**

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

(d) .4(5,000) ÷ [.4(5,000) + .6(10,000 + 121 + 8,000)] × ($12,000 undistributed earnings + $18,000 interest add-back) = $4,661
Reallocation of undistributed earnings = $4,661

*Including both the options and the convertible bonds is dilutive to the basic EPS result; therefore, diluted EPS under this method would be reported as $2.83 per share.

Step 3—Under Scenario 1, Step 3 is not required to be completed because a second class of common stock for which diluted EPS is required to be presented does not exist.

Scenario 2—Two Classes of Common Stock with Different Dividend Rights

A3. Assume that Company XYZ had 10,000 shares of Class A common stock and 10,000 shares of Class B common stock outstanding during 20X1 and net income of $65,000. Each share of Class B common stock is convertible into one share of Class A common stock. The Class B shareholders are entitled to two votes per share, whereas the Class A shareholders are entitled to one vote per share. Further, the Class B shareholders have the right to receive common stock dividends. Class A shareholders receive 105 percent of any dividends declared on Class B common stock. Company XYZ's Class A common stock is regularly traded on a national exchange and widely held (that is, Class A shares are the first class of common stock), as compared with the Class B common stock, which is thinly traded and held by a small number of initial investors (also known as founders shares). In 20X1, $10,500 (or $1.05 per share) and $10,000 (or $1.00 per share) were distributed to the Class A and Class B shareholders, respectively.

A4. Assume further that on January 1, 20X1, Company XYZ granted options to employees to purchase 2,000 shares of Class A common stock at $50 per share and that the average market price of Company XYZ's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and a service period of 4 years (cliff-vesting). The Company expects all of the option awards to vest. Company XYZ's tax rate for 20X1 is 40 percent.

Step 1—Compute basic EPS for 20X1 using the two-class method

Net income		$65,000
Less dividends paid:		
Class A	$10,500	
Class B	10,000	20,500
Undistributed 20X1 earnings		$44,500

Allocation of undistributed earnings:

To Class A:
1.05(10,000) ÷ [1.05(10,000) + 1.0(10,000)] × $44,500 = $22,793
$22,793 ÷ 10,000 shares = $2.28 per share
To Class B:
1.0(10,000) ÷ [1.05(10,000) + 1.0(10,000)] × $44,500 = $21,707
$21,707 ÷ 10,000 shares = $2.17 per share

Basic EPS amounts:

	Class A	Class B
Distributed earnings	$1.05	$1.00
Undistributed earnings	2.28	2.17
Total	$3.33	$3.17

Step 2—Compute diluted EPS for the Class A shares

Antidilution Sequencing

	Increase in Earnings Available to Common Shareholders	Increase in Number of Common Shares	Earnings per Incremental Share
Options	—	121(a)	—
Class B conversion	$31,707(b)	10,000	$3.17

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:	
Exercise price	$50 × 2,000 = $100,000
Average unrecognized compensation cost	($10,000 + $7,500) ÷ 2 = $8,750
Excess tax benefit	{[($60 − $50) − $5] × 2,000} × 40% = $4,000
Shares repurchased	$112,750 ÷ $60 = 1,879
Incremental shares	2,000 − 1,879 = 121 shares

(b) Amount represents the aggregate of the distributed ($10,000) and undistributed earnings ($21,707) allocated to the Class B common shareholders in the basic EPS computation.

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

	Undistributed & Distributed Earnings to Class A Common	Class A Common Shares	Earnings per Share
As Reported—Basic	$33,293(c)	10,000	$3.33
Options	—	121(a)	
	33,293	10,121	3.29
Class B Conversion	31,707(b)	10,000	
Diluted EPS for Class A common stock	**$65,000**	**20,121**	**$3.23***

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

	Undistributed & Distributed Earnings to Class A Common	Class Common Shares	Earnings per Share
As Reported—Basic	$33,293(c)	10,000	$3.33
Add-back: Undistributed earnings allocated to Class B shares	21,707	—	
	55,000	10,000	5.50
Options	—	121(a)	
	55,000	10,121	5.43
Less: Undistributed earnings reallocated to Class B shares	(21,574)(d)	—	
Diluted EPS for Class A common stock	**$33,426**	**10,121**	**$3.30***

(c) Amount represents the aggregate of the distributed ($10,500) and undistributed earnings ($22,793) allocated to the Class A common shareholders.

(d) 1.0(10,000) ÷ [1.05(10,000 + 121) + 1.0(10,000)] × $44,500 total undistributed earnings = $21,574
Reallocation of undistributed earnings = $21,574

Step 3—Compute diluted EPS for the Class B shares using the two-class method

Net income		$65,000
Less dividends paid:		
Class A	$10,500	
Class B	10,000	20,500
Undistributed 20X1 earnings		$44,500

Calculation of Diluted EPS for Class B Assuming the Use of the Two-Class Method

	Undistributed & Distributed Earnings to Class B Common	Class B Common Shares	Earnings per Share
As Reported—Basic	$31,707(b)	10,000	$3.17
Reallocation of undistributed earnings to Class B shares	(133)(e)	—	

Diluted EPS for Class B common stock	**$31,574**	**10,000**	**$3.16***

(e) 1.0(10,000) ÷ [1.05(10,000 + 121) + 1.0(10,000)] × $44,500 = $21,574
Reallocation of undistributed earnings = $21,574 − $21,707
Reallocation of undistributed earnings = ($133)

*In this scenario, Company XYZ would disclose diluted EPS per Class A shares using the if-converted method ($3.23) because that amount is more dilutive than the result yielded from the two-class method ($3.30). Diluted earnings per Class B shares would be reported as $3.16, as determined by the two-class method in Step 3 above.

Scenario 2a—Two Classes of Common Stock with Different Dividend Rights

A5. Assume the same facts as those in Scenario 2, except that on January 1, 20X1, Company XYZ issues 500 30-year convertible bonds with an aggregate par value of $500,000. Each bond is convertible into 20 shares of Class A common stock (10,000 shares in total) and carries a coupon rate of 3 percent.

Step 1—Compute basic EPS for 20X1 using the two-class method

Net income		$65,000
Less dividends paid:		
Class A	$10,500	
Class B	10,000	20,500
Undistributed 20X1 earnings		$44,500

Allocation of undistributed earnings:

To Class A:
1.05(10,000) ÷ [1.05(10,000) + 1.0(10,000)] × $44,500 = $22,793
$22,793 ÷ 10,000 shares = $2.28 per share
To Class B:
1.0(10,000) ÷ [1.05(10,000) + 1.0(10,000)] × $44,500 = $21,707
$21,707 ÷ 10,000 shares = $2.17 per share

Basic EPS amounts:

	Class A	Class B
Distributed earnings	$1.05	$1.00
Undistributed earnings	2.28	2.17
Total	$3.33	$3.17

Step 2—Compute diluted EPS for the Class A shares

Antidilution Sequencing

	Increase in Earnings Available to Common Shareholders	Increase in Number of Common Shares	Earnings per Incremental Share
Options	—	121(a)	—
Convertible debt	$9,000(b)	10,000(b)	$.90
Class B conversion	$31,707(c)	10,000	$3.17

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:	
Exercise price	$50 × 2,000 = $100,000
Average unrecognized compensation cost	($10,000 + $7,500) ÷ 2 = $8,750
Excess tax benefit	{[($60 − $50) − $5] × 2,000} × 40% = $4,000
Shares repurchased	$112,750 ÷ $60 = 1,879
Incremental shares	2,000 − 1,879 = 121 shares

(b) Assumed conversion of the convertible bonds would result in 10,000 incremental shares and the add-back of $9,000 [$500,000 × 3% × (1 − 0.4)] = $9,000) in after-tax interest expense to undistributed earnings for the period.

(c) Amount represents the aggregate of the distributed ($10,000) and undistributed earnings ($21,707) allocated to the Class B common shareholders in the basic EPS computation.

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

	Undistributed & Distributed Earnings to Class A Common	Class A Common Shares	Earnings per Share
As Reported—Basic	$33,293(d)	10,000	$3.33
Options	—	121(a)	
	33,293	10,121	3.29
Convertible debt	9,000(b)	10,000(b)	
	42,293	20,121	2.10
Class B Conversion	31,707(c)	10,000	
Diluted EPS for Class A common stock	**$74,000**	**30,121**	**$2.46***

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

	Undistributed & Distributed Earnings to Class A Common	Class A Common Shares	Earnings per Share
As Reported—Basic	$33,293(d)	10,000	$3.33
Add-back: Undistributed earnings allocated to Class B shares	21,707	—	
	55,000	10,000	5.50
Options	—	121(a)	
	55,000	10,121	5.43
Convertible debt	9,000(b)	10,000(b)	
	64,000	20,121	3.18
Less: Undistributed earnings reallocated to Class B shares	(17,188)(e)	—	
Diluted EPS for Class A common stock	**$46,812**	**20,121**	**$2.33***

(d) Amount represents the aggregate of the distributed ($10,500) and undistributed earnings ($22,793) allocated to the Class A common shareholders.

(e) 1.0(10,000) ÷ [1.05(10,000 + 121 + 10,000) + 1.0(10,000)] × ($44,500 undistributed earnings + $9,000 interest add-back) = $17,188

Step 3—Compute diluted EPS for the Class B shares using the two-class method

Net income		$65,000
Less dividends paid:		
Class A	$10,500	
Class B	10,000	20,500
Undistributed 20X1 earnings		$44,500
Assumed conversion of convertible bonds		9,000
Undistributed 20X1 earnings assuming conversions		$53,500

Calculation of Diluted EPS for Class B Assuming the Use of the Two-Class Method

	Undistributed & Distributed Earnings to Class B Common	Class B Common Shares	Earnings per Share
As Reported—Basic	$31,707(c)	10,000	$3.17
Reallocation of undistributed earnings to Class A shares from Class B shares	(4,519)(f)	—	
Diluted EPS for Class B common stock	**$27,188**	**10,000**	**$2.72***

(f) 1.0(10,000) ÷ [1.05(10,000 + 121 + 10,000) + 1.0(10,000)] × ($44,500 undistributed earnings + 9,000 interest add-back) = $17,188
Reallocation of undistributed earnings = $17,188 − $21,707
Reallocation of undistributed earnings = ($4,519)

*In this scenario, Company XYZ would disclose diluted EPS per Class A shares using the two-class method ($2.33) because the assumed conversion of Class B shares using the if-converted method ($2.46) is less dilutive than the result yielded from the two-class method. Diluted earnings per Class B shares would be reported as $2.72, as determined by the two-class method in Step 3 above.

Scenario 3—Common Stock with Participating Nonvested Shares

A6. Assume that Company XYZ had 25,000 shares of common stock outstanding during 20X1 and net income of $65,000. On January 1, 20X1, the company issued 2,500 nonvested shares to employees, each with a grant-date fair value of $50, that vest at the end of 4 years. As of December 31, 20X1, the company expects all of the awards to vest. The nonvested shareholders have a nonforfeitable right to participate in dividends with common shareholders on a dollar-for-dollar basis.

A7. For 20X1, the common shareholders have been paid $25,000 (or $1.00 per share), and the nonvested shareholders have been paid $2,500 (or $1.00 per share) in dividends (assume no tax benefit). Additionally, on January 1, 20X1, the company issued 1,000 30-year convertible bonds with an aggregate par value of $1,000,000. Each bond is convertible into 8 shares of common stock and carries a coupon rate of 3 percent. Assume further that, on January 1, 20X1, Company XYZ granted options to employees under a share-based payment award to purchase 2,000 shares of common stock at $50 per share and that the average market price of Company XYZ's common stock for the year was $60 per share. The options have a grant-date fair value of $5 and vest at the end of 4 years (cliff-vesting). The Company expects all of the option awards to vest. Company XYZ's tax rate for 20X1 is 40 percent.

Step 1—Compute basic EPS for 20X1 using the two-class method

Net income		$65,000
Less dividends paid:		
Nonvested shares	$2,500	
Common shares	25,000	27,500
Undistributed 20X1 earnings		$37,500

Allocation of undistributed earnings:

To nonvested shares:
2,500 ÷ (2,500 + 25,000) × $37,500 = $3,409
$3,409 ÷ 2,500 shares = $1.36 per share
To common:
25,000 ÷ (2,500 + 25,000) × $37,500 = $34,091
$34,091 ÷ 25,000 shares = $1.36 per share

Basic EPS amounts:

	Nonvested	Common
Distributed earnings	$1.00	$1.00
Undistributed earnings	1.36	1.36
Total	$2.36	$2.36

Step 2—Compute diluted EPS for the Class A common shares

Antidilution Sequencing

	Increase in Earnings Available to Common Shareholders	Increase in Number of Common Shares	Earnings per Incremental Share
Options	—	121(a)	—
Convertible bonds	$18,000(b)	8,000(b)	$2.25
Nonvested shares	$5,909(d)	510(c)	$11.59

(a) Incremental shares outstanding from assumed exercise of the outstanding options:

Assumed proceeds:	
Exercise price	$50 × 2,000 = $100,000
Average unrecognized compensation cost	($10,000 + $7,500) ÷ 2 = $8,750
Excess tax benefit	{[($60 − $50) − $5] × 2,000} × 40% = $4,000
Shares repurchased	$112,750 ÷ $60 = 1,879
Incremental shares	2,000 − 1,879 = 121 shares

(b) Assumed conversion of the convertible bonds would result in 8,000 incremental shares and the add-back of $18,000 [$1,000,000 × 3% × (1 − 0.4)] = $18,000) in after-tax interest expense to undistributed earnings for the period.

(c) Incremental shares outstanding from assumed conversion of the outstanding nonvested shares:

Assumed proceeds:	
Average unrecognized compensation cost	($125,000 + $93,750) ÷ 2 = $109,375
Excess tax benefit	[($60 − $50) × 2,500] × 40% = $10,000
Shares repurchased	$119,375 ÷ $60 = 1,990
Incremental shares	2,500 − 1,990 = 510 shares

(d) Amount represents the aggregate of the distributed ($2,500) and undistributed earnings ($3,409) allocated to the nonvested shareholders.

Calculation of Diluted EPS Assuming the Effect of All Potentially Dilutive Securities

	Undistributed & Distributed Earnings to Common	Common Shares	Earnings per Share
As Reported—Basic	$59,091(e)	25,000	$2.36
Options	—	121(a)	
	59,091	25,121	2.35
Convertible debt	18,000(b)	8,000(b)	
	77,091	33,121	2.33
Nonvested shares	5,909(d)	510(c)	
Diluted EPS for common stock	**$83,000**	**33,632**	**$2.47***

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

	Undistributed & Distributed Earnings to Common	Common Shares	Earnings per Share
As Reported—Basic	$59,091(e)	25,000	$2.36
Add-back: Undistributed earnings allocated to nonvested shares	3,409	—	
	62,500	25,000	2.50
Options	—	121(a)	
	62,500	25,121	2.49
Convertible debt	18,000(b)	8,000(b)	
	80,500	33,121	2.43
Less: Undistributed earnings reallocated to nonvested shares	(3,895)(f)	—	
Diluted EPS	**$76,605**	**33,121**	**$2.31***

(e) Amount represents the aggregate of the distributed ($25,000) and undistributed earnings ($34,091) allocated to the common shareholders.

(f) 2,500 ÷ (25,000 + 121 + 8,000 + 2,500) × ($37,500 undistributed earnings + $18,000 interest add-back) = $3,895

*In this scenario, Company XYZ would disclose diluted EPS per common share using the two-class method ($2.31) because the assumed vesting of the nonvested shares (using the treasury stock method) yields a less dilutive result ($2.47).

Step 3—Under Scenario 3, Step 3 is not required to be completed because a second class of common stock for which diluted EPS is required to be presented does not exist.