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Computing earnings per share: unofficial accounting interpretations of APB Opinion no. 15

J. T. Ball

Computing Earnings per Share

UNOFFICIAL ACCOUNTING INTERPRETATIONS OF APB OPINION NO. 15

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American Institute of Certified Public Accountants

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The Institute staff has been authorized to issue unofficial interpretations of accounting questions having general interest to the profession (see Exhibit 1, page 106). The purpose of the Interpretations is to provide guidance on a timely basis without the formal procedures required for an Accounting Principles Board Opinion. These Interpretations, which are reviewed with informed members of the profession, are unofficial and tentative unless confirmed by the Board in an Opinion. Responsibility for their preparation rests with Richard C. Lytle, *administrative director of the Accounting Principles Board, and* J. T. Ball, *research associate for accounting interpretations.*

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INTRODUCTION

Comparison of APB Opinions No. 9 and 15

APB Opinion No. 15, *Earnings per Share,* is an extension of the issues discussed in Part II, "Computation and Reporting of Earnings Per Share," of APB Opinion No. 9.

APB Opinion No. 9 included certain "residual" securities as the equivalent of common stock in earnings per share computations, established "supplementary pro forma" earnings per share for reporting what the effect on earnings per share would have been if all residual and contingently issuable securities had been issued, and strongly recommended that both earnings per share and supplementary pro forma earnings per share be disclosed in the income statement.

APB Opinion No. 15 supersedes Part II of APB Opinion No. 9, modifies the concept of residual securities and replaces the term *residual securities* with the new designation *common stock equivalents.* Under the Opinion, dilutive common stock equivalents are included with outstanding common stock in computing "primary" earnings per share. Common stock, dilutive common stock equivalents and other potentially dilutive securities are included in computing "fully diluted" earnings per share.

The Opinion requires that earnings per share be presented on the face of corporate income statements or summaries of such statements with both the primary and fully diluted amounts presented when potential dilution of earnings per share exists. Also, APB Opinion No. 15 specifically prohibits including anti-dilutive[1] securities in

[1]See Interpretation 5 for the definition of an anti-dilutive security.

earnings per share computations (except in special situations to be discussed later) while APB Opinion No. 9 discussed dilution but did not specifically prohibit anti-dilution.

Interpretation of APB Opinion No. 15

These Unofficial Accounting Interpretations are intended to explain the provisions of APB Opinion No. 15. They do not in any way amend or modify the Opinion. They do not presume to answer all questions which might be raised in applying the Opinion but rather are addressed to questions raised since the Opinion was issued.

Some Interpretations are concerned with simple situations; others are concerned with rather complex situations. And just as APB Opinions are not necessarily applicable to immaterial items, these Interpretations do not necessarily apply to immaterial items. In many cases the refinements described will be material, but in many other cases they will not. When the difference is not significant, the refinements need not be applied. For example, the quarterly share averaging procedure for options and warrants described in Interpretations 58-62 need not be used when the market price of common stock is stable throughout the year and always above the exercise price. In such a case the treasury stock method could be applied on an annual basis.

Although the Interpretations are not binding on Institute members, they reflect informed consideration of the situations posed and express what the Institute staff believes to be the preferred practices for earnings per share computations under the Opinion.

Arrangement

This booklet of Interpretations of APB Opinion No. 15 is divided into two parts. Part I is an overview of the Opinion. Although Part I summarizes the basic provisions of the Opinion, familiarity with the Opinion is assumed and terms used in the Opinion are not defined in this part. Part I also serves as a brief description of the underlying concepts of the Opinion. Part II contains definitional Interpretations followed by individual Interpretations in question and answer form. The Interpretations are numbered sequentially and are arranged generally in the order in which the topics appear in Part I. Exhibits follow Part II, and the complete Opinion is reproduced in the back part of this booklet. Following the Opinion, a cross-reference table appears which lists each Opinion paragraph cited (as explained below) and the location of the citation.

The content of each page is identified in the heading at the top of the page. The *first* material on the left-hand page is identified at the top of that page; the *last* material on the right-hand page is identified at the top of that page. Page numbers appear on the bottom of pages. **Numbers and notations appearing in the outside margins beside the text are cross-references to Opinion paragraphs, Opinion footnotes, and exhibits in Opinion appendices** relevant to the material being discussed.

PART I: AN OVERVIEW OF APB OPINION NO. 15

Presentation of Earnings per Share

The Opinion requires nearly all corporations[2] to report earnings
12 per share data on the face of income statements or earnings summaries
issued for periods beginning after December 31, 1968. Each presenta-
13 tation must include per share data for income or loss before extra-
ordinary items (if extraordinary items are reported on the income
statement) and per share data for net income or loss. Corporations
with capital structures containing securities that do not, in the
14 aggregate, dilute earnings per share 3% or more need present only
earnings per common share. This exception for corporations whose
securities do not dilute earnings per share by at least 3% is based
upon the immateriality of dilution of less than 3%. In this Opinion
the Board specified the point at which dilution becomes material rather
than allowing different judgments to determine different levels of
15 materiality. All other corporations are required to have the "dual"
presentation of primary earnings per share and fully diluted earnings
per share. All computations of earnings per share data are to be
47 based on a weighted average of shares assumed to be outstanding
during the period.

Assumptions

Earnings per share computations for corporations with complex
20 capital structures are based on various assumptions which are required
by the Opinion. These assumptions are made to reflect (1) what a
corporation's earnings per share would have been if common stock
24-27 had been issued to replace all dilutive securities considered to be the
equivalent of common stock and (2) the additional dilution which

[2]See Interpretation 9 for the exceptions.

would have resulted if common stock had been issued to replace all of the corporation's other potentially dilutive securities.[3] 41

Assumptions to be made are specified for exercise, conversion, and issuance of securities, prices to be used, and methods to be applied to reflect the dilution which would have resulted if the transactions and events underlying those assumptions had actually occurred. Although specific methods for applying the assumptions are designated, the Board realized that the events and transactions assumed for the computations might not actually occur. Rather, the Board specified the assumptions and the methods as a practical approach 34, 36
to obtaining comparable determinations of earnings per share.

Classification of Securities

The advent of securities which are not common stock in form 25
but which enable their holders to obtain common stock modifies some of the traditional relationships among securities. While common stock is regarded as the basic equity security and nonconvertible preferred stock and nonconvertible debt are regarded as senior securities, those securities which enable their holders to obtain common stock are classified as either *common stock equivalents* or as *other potentially* 41
dilutive securities for earnings per share computations. This classification is made at time of issuance and does not change thereafter.[4] 28

A security is classified solely for purposes of determining earnings 39
per share. The accounting for securities, their presentation in the financial statements, and the determination of book value per share are not affected by the classification of securities for earnings per share computations.

Common stock equivalents are included in both primary and fully 15
diluted earnings per share computations. Other potentially dilutive securities are included only in fully diluted earnings per share computations. However, common stock equivalents and other potentially dilutive securities are included in the *computations* only when their effect is dilutive. Both are excluded from the *computations* whenever their effect is anti-dilutive except in the situations described in the following paragraph. Thus, a security retains its status as a common stock equivalent or as an other potentially dilutive security after its

[3]See Interpretation 3 for the special context in which the term *other potentially dilutive securities* is used in these Unofficial Accounting Interpretations of APB Opinion No. 15. The term is not used in the Opinion.
[4]Except as explained in Interpretations 29 and 30.

30 classification has been determined, but it may enter earnings per share
computations in one period and not in another period.

Anti-Dilutive Securities

30, 40 Anti-dilutive securities are excluded from earnings per share
41 computations unless (1) common stock was issued during the period
on an anti-dilutive exercise or conversion or (2) a security is anti-
fn. 8, 14 dilutive in earnings per share for income before extraordinary items
but is dilutive in earnings per share for net income or vice versa[5]
38 or (3) an aggregate computation is required which has a net dilutive
effect but which may include anti-dilutive securities or anti-dilutive
30, 40 computations.[6] All other anti-dilutive securities are excluded from
earnings per share computations even when some anti-dilutive securi-
ties are included in the computation because of one or more of the
38 above exceptions. In an aggregate computation, only when the net
result is dilutive may anti-dilutive securities be included in the earnings
per share computation.

Primary Earnings per Share

Primary earnings per share data are based upon outstanding com-
mon stock and common stock assumed to be outstanding to reflect the
dilutive effect of common stock equivalents. Convertible securities
33 which yield less than two-thirds of the bank prime interest rate at
the time of issuance are classified as common stock equivalents.
28 Convertible securities issued with the same terms as those of an
outstanding common stock equivalent are classified as common stock

[5]Note that either primary earnings per share for net income or primary earnings per share for income before extraordinary items may be anti-dilutive when common stock equivalents are present together with extraordinary items. The common stock equivalents may have an anti-dilutive effect upon either of these amounts so long as the effect is dilutive upon the other amount. The same type of anti-dilution may be reflected *within* fully diluted earnings per share when common stock equivalents and other potentially dilutive securities are present together with extraordinary items. However, fully diluted earnings per share for net income would *not* be anti-dilutive with respect to primary earnings per share for net income unless the anti-dilution is caused by actual exercises or conversions.

[6]For example, an aggregate computation is required by Opinion paragraph 38 when the number of common shares issuable upon the exercise of all options, warrants, and their equivalents exceeds 20% of the number of common shares outstanding at the end of the period for which the computation is being made. An aggregate computation would also be made for an anti-dilutive option which must be exercised before a dilutive option may be exercised. (See Interpretation 49.)

equivalents regardless of their yield. Outstanding convertible securities which are not common stock equivalents become common stock equivalents if another convertible security with the same terms is issued and is classified as a common stock equivalent.

Convertible securities which allow or require the payment of cash 37
at conversion are considered the equivalents of warrants. Options,
warrants and their equivalents, stock purchase contracts, and certain
agreements to issue common stock in the future are classified as
common stock equivalents. Some participating securities and two- 27
class common stocks are also classified as common stock equivalents.

Fully Diluted Earnings per Share

Fully diluted earnings per share data are based on outstanding
common stock and common stock assumed to be outstanding to reflect
the maximum dilutive effect of common stock equivalents and other 40
potentially dilutive securities. Thus, convertible securities, options,
warrants, stock purchase contracts, participating securities, two-class
common stocks and agreements to issue stock in the future are
included in the computation of fully diluted earnings per share. The
difference between the primary and the fully diluted earnings per 16
share amounts is the additional dilution resulting from other potentially dilutive securities outstanding.

Earnings Applicable to Common Stock

To compute earnings per share, net income must often first be
adjusted to determine earnings applicable to common stock. The
adjustments to net income do not in any way change reported net 39
income but rather are made to compute the earnings for the period
to which common stock has a claim. Corporations with nonconvertible
preferred stock, for example, must deduct any preferred dividends 50
paid, declared, or accumulated for the period in adjusting net income
to determine earnings applicable to common stock.

Only dividends which are applicable to the period covered by the income statement would be deducted. Dividends declared or accumulated during a prior period and paid during the period covered by the income statement are not deducted since they were considered in computing earnings applicable to common stock during the prior period and their payment merely retires the liability.

Corporations with common stock equivalents or other potentially dilutive securities may have to make more complex adjustments or

may not make some adjustments which would otherwise be made.
51 For example, interest, less tax effect, on convertible bonds deducted
in arriving at net income would be added back to net income to
determine earnings applicable to common stock when the convertible
52 bonds are assumed to be converted. Since dividends on convertible
preferred stock are not deducted in arriving at net income, they would
not be added back to net income to determine earnings applicable
to common stock when convertible preferred stock is assumed to be
converted.

Convertible Securities

Convertible securities are included in earnings per share compu-
51 tations under the "if converted" method. Under this method, the
security is assumed to have been converted into common stock at
the beginning of the period being reported upon (or time of issuance
of the security, if later). The common stock which would have been
issued upon conversion is considered outstanding from the date of
the assumed conversion. Interest deductions applicable to convertible
debt reduced by the income taxes attributable to such interest are
added back to net income because the interest would not have been
incurred if the debt had been converted into common stock. Non-
discretionary adjustments based on net income or income before
taxes (for items such as profit sharing or royalty agreements, etc.)
are recomputed after the interest adjustment is made. Any difference
(less income tax) from the amount originally computed is also
included in the adjusted net income.

35 Convertible securities which *require* the payment of cash at
conversion are considered the equivalent of warrants for computa-
37 tional purposes. Both the treasury stock method and the if converted
method must be applied. Convertible securities which *permit* the
payment of cash as an alternative at conversion are also considered
the equivalent of warrants. But when conversion without the payment
of cash would be more advantageous to the holder with this alter-
native, only the if converted method is applied. No proceeds would
be received to which the treasury stock method could be applied.

30, 40 When conversion is not assumed because the result would be
50 anti-dilutive, dividends declared for the period (or accumulated for
the period even though not declared) are deducted from net income
to determine earnings applicable to common stock.

Options and Warrants

The basic method for including options and warrants and their equivalents in earnings per share computations is the treasury stock method. Under this method, exercise of options and warrants and their equivalents is assumed at the beginning of the period (or time of issuance, if later). Shares of common stock are assumed to be issued and the proceeds from exercise are assumed to be used to purchase common stock at the exercise date. Common stock outstanding is assumed to increase by the difference between the number of shares issued and the number of shares purchased. The provision against reflecting anti-dilution in earnings per share computations generally prohibits the assumption of exercise of any option or warrant or their equivalents when the assumed purchased price of the common stock is below the exercise price of the option or warrant. 36, 42

The Opinion recommends as a practical matter that exercise not be assumed for earnings per share computations until the market price of the common stock has been higher than the exercise price for substantially all of three consecutive months ending with the last month of the period for which the share computation is being made. Thus, exercise need not be assumed until this three-month test has once been met. 36

After the test has been met, however, an ending market price which is above the average market price is used for fully diluted computations if the result is dilutive. Therefore, options and warrants may be reflected in fully diluted earnings per share even though they are not reflected in primary earnings per share. Options and warrants may also be included in the computations in some periods but not be included in other periods. 42

Some warrants require or permit the tendering of debt or other securities in payment of all or part of the exercise price. Upon the assumed exercise of such warrants, the debt or other securities are assumed to be tendered (unless tendering cash would be more advantageous to the warrant holder when permitted and the treasury stock method is applied). Interest, net of income tax, on any debt tendered is added back to net income. The treasury stock method is applied for proceeds assumed to be received in cash. 37

The proceeds from the exercise of some warrants must be applied to retire debt under the terms of the debt. Upon the assumed exercise of such warrants, the proceeds are applied to purchase the debt at its market price rather than to purchase common stock under the treasury stock method. The treasury stock method is applied, however, for excess proceeds from the assumed exercise. Interest, net of income tax, on any debt assumed to be purchased is added back to net income.

Some convertible securities require or permit the payment of cash upon conversion and are considered the equivalent of warrants. The treasury stock method must be applied to purchase common stock from proceeds assumed to be received. The if converted method must also be applied for the convertible security.

38 The application of the treasury stock method is modified when the number of common shares which would be issued if all outstanding options and warrants and their equivalents were exercised exceeds 20% of the number of common shares outstanding at the end of the period. This 20% test is based only on common shares actually outstanding, not considering any assumed conversion or contingently issuable shares.

35, 38 When the 20% test is met, *all* options and warrants and their equivalents are assumed to be exercised (or converted) regardless of whether each would be dilutive or anti-dilutive. The treasury stock
38 method is first applied to purchase no more than 20% of the number of common shares outstanding at the end of the period with the proceeds from exercise. The balance of any proceeds remaining after applying the treasury stock method is then applied to reduce any short-term or long-term debt of the issuer to the extent that the debt may be retired. Finally, any remaining balance of proceeds is assumed to be invested in U.S. government securities or commercial paper. Appropriate recognition is given to any necessary interest adjustments (and related income tax effect) for both debt retirement and investment in determining earnings applicable to common stock.

The results of the foregoing computations are then aggregated. If the net aggregate effect is dilutive, *all* of these computations enter into earnings per share computations. However, *all* are omitted if the net aggregate effect is anti-dilutive. (See Interpretation 74 for a description of the distinction between the 20% test and the 20% limitation.)

Delayed Effectiveness and Changing Rates or Prices

56 Some convertible securities are not convertible until a future date or their conversion rates may increase or decrease in the future.

Similarly, some options or warrants are not exercisable until a future date or their exercise prices may increase or decrease in the future.

For primary earnings per share computations, the conversion rate 57
or exercise price in effect for the period presented is used. If the holder does not have the right to convert or exercise the security until after that period, the earliest effective conversion rate or exercise price during the five years following the close of the period is used.

For fully diluted earnings per share computations, the most 58
advantageous conversion rate or exercise price (to the security holder) becoming effective within ten years following the close of the period being reported upon is used.

Other Securities

Although the Opinion does not describe in depth the treatment to be accorded to other types of securities, they were contemplated by the Opinion and some guidelines given. The earnings per share treatments of two-class common stock, participating securities, common stock issuable in the future upon the satisfaction of specified conditions, securities of subsidiaries, and options or warrants to purchase convertible securities are discussed in the Interpretations which
follow in Part II. Situations or securities not expressly covered in the 43
Opinion should be dealt with in accordance with their substance following the guidelines and criteria of the Opinion and these Unofficial Accounting Interpretations.

Restatement of Previously Reported Data

The earnings per share amounts reported in a prior period generally will be reported at the same amounts when that prior period is included in a later comparative income statement. The Opinion
specifically prohibits retroactive restatement (1) for changes in market 36, 41
prices of common stock when the treasury stock method has been
applied for options and warrants, (2) when conversion rates of con- 57
vertible securities or exercise prices of options or warrants change,
(3) when convertible securities are actually converted, and (4) for 22, 41
primary earnings per share, when the number of shares issued upon 62
the attainment of increased earnings levels differs from the number of shares previously considered outstanding.

The Opinion requires retroactive restatement (1) to give effect
to prior period adjustments,[7] (2) to give effect to stock dividends, 18
stock splits, and reverse splits, including those occurring after the 48

[7]As defined in paragraphs 23 and 24 of APB Opinion No. 9.

49 close of the period being reported upon, (3) to give effect to a pooling
63 of interests, (4) to give effect to changes in the number of shares contingently issuable or issued when such changes are caused by changes
62 in market prices of the stock, and (5) to give effect to a reduction in the number of shares contingently issuable when the term of an agreement to issue additional shares expires and the conditions have not been met.[8]

45 The Opinion recommends retroactive restatement of earnings per share data for periods beginning before January 1, 1969 when such data are presented in comparative income statements including a period beginning after December 31, 1968 and election "b" of
46 Opinion paragraph 46 has been made. Retroactive restatement of such data is required, however, when election "a" of Opinion paragraph 46 has been made. Otherwise, part of the data would conform to the provisions of Part II of APB Opinion No. 9 which is superseded by APB Opinion No. 15.

Business Combinations and Reorganizations

49 A business combination accounted for as a purchase of another business should, in the weighted average of shares, give effect to additional securities issued only from the date of acquisition. Results of operations of the acquired business are also included in the statement of income only from the date of acquisition.

In a pooling of two or more corporations, the weighted average outstanding securities of the constituent corporations adjusted to the equivalent securities of the surviving corporation should be used for the earnings per share computation for all periods presented. The results of operations of the constituent businesses are also combined for all periods presented.

After a reorganization or quasi-reorganization, the earnings per share computations should be based on an analysis of the particular transaction applying the guidelines of the Opinion.

Disclosure

19 Disclosure is required to explain the rights and privileges of the
20 holders of the various securities outstanding; the bases upon which

[8]But note that restatement is prohibited for primary earnings per share when increased earnings levels are attained and shares are issued which were not previously considered outstanding for prior primary computations. (See point 4 in the preceding paragraph and Opinion paragraph 62.)

primary and fully diluted earnings per share were computed; the number of shares issued upon conversion, exercise or satisfaction of required conditions; and other information necessary for a clear understanding of the data presented. (For example, if the fully diluted amount is the same as the primary amount because certain 15-16
anti-dilutive securities which are not common stock equivalents are omitted from the fully diluted computation, that fact would be disclosed.)

Supplementary Data

Supplementary earnings per share data[9] are to be furnished for 22-23
the latest period when conversion occurs and primary earnings per share would have increased or decreased at least 3% if the conversion fn. 2
had occurred at the beginning of the period. Supplementary data are also to be furnished when common stock or common stock equivalents are sold and the proceeds are used to retire preferred stock or debt. 23
It may also be desirable to furnish supplementary earnings per share 22
data for each period presented giving the cumulative retroactive effect of all such issuances.

Supplementary data show what primary earnings per share would have been if the situations described above had occurred at the beginning of the period being reported upon rather than during the period. Thus, supplementary data are helpful for reflecting the trend of earnings per share data when primary amounts are affected by an increase in the number of shares included in the computation without an increase in the capital employed in the business.

Effective Date

APB Opinion No. 15 is effective for fiscal periods beginning after 45
December 31, 1968. Earnings per share must therefore be reported on the faces of all income statements for periods beginning January 1, 1969 and thereafter. Securities are to be classified under the provisions of the Opinion regardless of the time of issuance except that an election is granted for securities with a time of issuance prior 46
to June 1, 1969 for computing primary earnings per share to either:

[9]Supplementary earnings per share data should not be confused with fully diluted earnings per share. As used in APB Opinion No. 15, "supplementary earnings per share data" are additional data which are disclosed in a note. (APB Opinion No. 9 used the term "supplementary pro forma earnings per share" to describe data which are described as "fully diluted earnings per share" in APB Opinion No. 15.)

(a) classify all such securities under the provisions of the Opinion, i.e., apply the Opinion retroactively regardless of when the securities were issued, or

(b) classify all securities outstanding[10] at May 31, 1969 as common stock equivalents if they were residual securities under APB Opinion No. 9.

All securities subject to the election must be classified under election "a" or all securities must be classified under election "b." The election may not be changed after it is made. Thus, the classifications of all securities issued prior to June 1, 1969 once determined under election "a" or election "b" never change.[11] All securities with a time of issuance after May 31, 1969 must be classified under the provisions of APB Opinion No. 15.

Election "b" allows a corporation to ignore options and warrants issued before June 1, 1969 in primary earnings per share computations unless they were considered residual securities under APB Opinion No. 9. The election was provided because the Board has traditionally not made its Opinions retroactive. This Opinion therefore does not apply new rules to securities which were issued under a prior Opinion and which were already outstanding when APB Opinion No. 15 was issued.

The election applies only to primary earnings per share computations. Fully diluted earnings per share computations include all common stock equivalents and other potentially dilutive securities without regard to the election. However, supplementary pro forma earnings per share determined under APB Opinion No. 9 are not necessarily the same[12] as fully diluted earnings per share determined
45 under APB Opinion No. 15. Therefore, the Board recommends that previously reported earnings per share data be restated when reported in comparative income statements including an earnings per share amount computed under the provisions of APB Opinion No. 15 if election "b" of Opinion paragraph 46 has been made. Restatement for

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[10]Securities no longer outstanding at May 31, 1969 are classified as common stock equivalents if they were residual securities under APB Opinion No. 9 at the statement date. This applies only for income statements for periods prior to May 31, 1969 when such income statements are subsequently included in comparative income statements after that date.

[11]See Interpretations 29 and 30 for exceptions.

[12]Although pro forma earnings per share and fully diluted earnings per share could be the same, they might be different. Any differences would result principally from the anti-dilution provisions of APB Opinion No. 15 and from different computational methods for options and warrants.

all prior periods presented is accomplished by retroactively applying (1) the security classifications determined under election "b" and (2) the computational methods prescribed by APB Opinion No. 15. 46

Both primary and fully diluted earnings per share amounts for prior periods must be retroactively restated if election "a" of Opinion paragraph 46 has been made when the prior period data are reported in comparative income statements including earnings per share data computed under the provisions of APB Opinion No. 15.

PART II: UNOFFICIAL ACCOUNTING INTERPRETATIONS OF APB OPINION NO. 15

DEFINITIONAL INTERPRETATIONS

1. Security

The term *security* is used in APB Opinion No. 9, APB Opinion
No. 15 and in these Interpretations in a broad context to include
27 instruments not usually considered to be securities. Securities are
usually thought of as being common stocks, preferred stocks (both
nonconvertible and convertible), bonds (both ordinary and con-
vertible), and warrants. In a broad context, the term *security* also
includes all debt instruments, options to purchase stock (or other
securities), stock purchase contracts, stock subscriptions, and agree-
37 ments to issue stock (or other securities) at a future date. Several
securities may be included in a single instrument, which may or may
not be separable.

2. Common Stock Equivalents

A common stock equivalent is defined by the Opinion as: "A
security which, because of its terms or the circumstances under which
it was issued, is in substance equivalent to common stock." (See page
173 in the Opinion.) A common stock equivalent is not common
25 stock in form but rather derives a large portion of its value from its
common stock characteristics or conversion privileges. Such a security
typically contains provisions enabling its holder to become a common
stockholder. Its value tends to change with changes in the value of
the common stock to which it is related. Examples of common stock
35 equivalents are: options and warrants, preferred stock or debt con-
33 vertible into common stock if the stock or debt yields less than $66\frac{2}{3}\%$

of the bank prime interest rate at time of issuance, and agreements to 27
issue common stock with the passage of time as the only condition to issuance.

3. Other Potentially Dilutive Securities

Other potentially dilutive securities is a term used in this Interpretation to designate a classification of securities which are similar to common stock equivalents but which for one reason or another do not meet the tests for common stock equivalents under the Opinion.[13] Other potentially dilutive securities are included only in fully diluted earnings per share computations while common stock equivalents are, in effect, included in both primary and fully diluted earnings per share computations.

Examples of other potentially dilutive securities are convertible
senior securities (convertible preferred stock and convertible debt) 41
and options or warrants issued prior to June 1, 1969 if election "b" 46
of Opinion paragraph 46 is made[14] and the options or warrants were not classified as residual securities under APB Opinion No. 9.

4. Dilution — Dilutive Security

Dilution, as used in the Opinion, is a reduction of the amount fn. 2
which would otherwise be reported as earnings per share. A dilutive security is a security which results in a decrease in the amount reported as earnings per share. As explained in Interpretations 5 and 15, there
is no dilution of net loss per share when a corporation reports a net 30, 40
loss on its income statement.

A dilutive security increases the number of common shares which are considered to be outstanding during the period for which the earnings per share computation is being made. Thus, a dilutive security increases the denominator used in the earnings per share

[13]The term is not used in the Opinion in this strict context. *Potentially dilutive securities,* as that term is used in the Opinion, includes common stock equivalents. (For example, see Opinion paragraph 14.) The Opinion discusses convertible senior securities which are not common stock equivalents and other contingent issuances which are not common stock equivalents. Securities which are *not* common stock equivalents but which enable their holders to obtain common stock are described in these Interpretations as "*other* potentially dilutive securities." Therefore, convertible senior securities described in the Opinion are classified as "other potentially dilutive securities" in these Interpretations.

[14]See Interpretation 46 for an explanation of why these options and warrants are not classified as common stock equivalents.

51 computation. Earnings applicable to common stock, the numerator in the computation, may also increase. But so long as the numerator increase per additional denominator share is less than earnings per outstanding share, the security will be dilutive.

5. Anti-Dilution — Anti-Dilutive Security

30, 40 Anti-dilution is an increase in the amount which would otherwise be reported as earnings per share or a decrease in the amount of the net loss per share. Anti-dilution therefore has an incremental effect on earnings per share data. An anti-dilutive security is a security which would result in an increase in the amount reported as earnings per share or a decrease in the amount reported as net loss per share.

When a net income is reported, an anti-dilutive option or warrant under the treasury stock method reduces the number of common shares considered outstanding during a period. Such options or warrants, if permitted to enter the computation, would increase earnings per share by reducing the denominator used. Anti-dilutive convertible debt would increase the denominator. However, its interest adjustment would increase earnings applicable to common stock, the numerator used in the computation, by a greater amount per additional share than earnings per share computed without assuming conversion. Any numerator increase per additional denominator share which is greater than earnings per share computed without assuming conversion would have an incremental effect on earnings per share and would be anti-dilutive. Convertible preferred stock is anti-dilutive when its dividend per common share obtainable upon conversion exceeds earnings per share computed without assuming conversion.

When a net loss is reported, exercise or conversion is not assumed.[15] Any computation is anti-dilutive which increases the number of shares considered outstanding during a period for which a net loss is reported. Exercise of options and warrants is not assumed since this would increase the number of shares considered outstanding. Likewise, conversion would increase the number of shares considered outstanding. In addition, the if converted adjustments for convertible debt would decrease the amount of the loss. Not deducting dividends on convertible preferred stock would also decrease the amount of the loss applicable to common stock.

[15]See footnote 5 in Part I.

6. Dual Presentation

The dual presentation has two groups of earnings per share data; 16
one is primary earnings per share data and the other is fully diluted earnings per share data. Both must be presented with equal prominence on the face of the income statement.

The dual presentation of primary and fully diluted earnings per
share data should not be confused with the two earnings per share 13
amounts which must be presented when a corporation reports extraordinary items on its income statement. Even when the dual presentation is not required, a corporation reporting extraordinary items must report (1) earnings per share for income before extraordinary items and (2) earnings per share for net income. When the dual presentation is required, a corporation reporting extraordinary items must report both amounts for primary earnings per share and both amounts for fully diluted earnings per share.

A corporation with no extraordinary items on its income statement would report only earnings per share for net income. But this must be reported for both primary and fully diluted earnings per share by a corporation when the dual presentation is required.

7. Primary Earnings per Share

Primary earnings per share is the amount of earnings attributable
to each share of common stock outstanding and common stock 15
assumed to be outstanding to reflect the dilutive effect of common
stock equivalents. Primary earnings per share data include an earnings
per share amount for income before extraordinary items and an 13
earnings per share amount for net income. These data may also include an earnings per share amount for extraordinary items.

Primary earnings per share is used in the Opinion and in these Interpretations as a convenient means of designating the presentation of these data which must appear on the face of an income statement of a corporation when the dual presentation is required. Thus, "primary" is a communication tool used merely to identify this group of earnings per share data to be presented and is not suggested as a caption to be used on the income statement. The term "primary" is not intended in any way to attribute greater significance to this group of data than is attributed to the fully diluted data.

8. Fully Diluted Earnings per Share

Fully diluted earnings per share is the amount of earnings attribut-
15 able to each share of common stock outstanding and common stock assumed outstanding to reflect the dilutive effect of common stock equivalents and other potentially dilutive securities. Fully diluted earnings per share data include an earnings per share amount for
13 income before extraordinary items and an earnings per share amount for net income. These data may include an earnings per share amount for extraordinary items.

Fully diluted earnings per share is used in the Opinion and in these Interpretations as a convenient means of designating the presentation of these data which must appear on the face of an income statement of a corporation when the dual presentation is required. Thus, "fully diluted" is a communication tool used merely to identify this group of earnings per share data to be presented and is not suggested as a caption to be used on the income statement.

APPLICABILITY OF THE OPINION

9. Corporations and Financial Presentations Excepted

Q—Does the Opinion require all corporations to present earnings per share on all income statements?

A—All corporations which are not specifically excepted by the Opinion must present earnings per share on the face of any income statement or summary of such a statement for periods beginning after December 31, 1968.

6 The only corporations excepted from the provisions of the Opinion are:

1. Mutual companies without common stock or common stock equivalents outstanding (for example, mutual savings banks, cooperatives, credit unions, etc.).
2. Companies registered under the Investment Company Act of 1940.
3. Corporations owned by political subdivisions or municipal, county, state, federal or foreign governments.
4. Not-for-profit corporations (for example, colleges, universities, medical or scientific research entities, trade and professional associations, religious organizations, etc. which are incorporated).

The Opinion applies to all financial presentations which purport
to present results of operations in conformity with generally accepted 5
accounting principles and to summaries of those presentations for all
corporations except those listed above. However, the following
financial presentations are also excepted from the provisions of the 6
Opinion:

1. Parent company statements accompanying consolidated financial statements.
2. Statements of wholly owned subsidiaries.
3. Special purpose statements.

Special purpose statements (as described in Chapter 13 of Statements on Auditing Procedure No. 33) by definition are not prepared in accordance with generally accepted accounting principles. Special purpose statements are not, however, merely those prepared for specific purposes if they purport to present results of operations in conformity with generally accepted accounting principles. For example, SEC Form S-9 for registration of certain high-grade, nonconvertible, fixed-interest debt securities requires disclosure of ratios of earnings to fixed charges for each year in the summary (or statement) of earnings. Although the SEC does not require that earnings per share data be reported in Form S-9, this form is not a "special purpose statement." Earnings per share must therefore be reported under APB Opinion No. 15.

10. Closely Held Corporations

Q—Does the Opinion apply to closely held corporations?

A—Yes, closely held corporations which are not wholly owned 5, 6
subsidiaries of other corporations must report earnings per share on their income statements in accordance with the Opinion. A corporation whose stock is all owned by a single individual is not a wholly owned subsidiary.

11. Dilution Less Than 3%

Q—Must a corporation with few dilutive securities outstanding make the dual presentation? May such a corporation ignore the dilutive securities and report earnings per share based on common shares outstanding?

A—The required reporting of earnings per share data depends on the materiality of the amount of dilution produced by securities

which enable their holders to obtain common stock in the future.
fn. 2 Aggregate dilution from all such securities which is less than 3% of earnings per common share outstanding need not be reported for either primary or fully diluted earnings per share, since such dilution is not considered to be material. Thus, if both the primary and fully diluted amounts are more than 97% of earnings per common share outstanding, earnings per share may be based on only common shares outstanding.

15 The 3% provision applies to fully diluted earnings per share compared to earnings per common share outstanding, not compared to primary earnings per share. Anti-dilutive securities are not dilutive by definition and should be excluded in computing aggregate dilution. The 3% provision also applies to the reporting of any other earnings per share information, such as supplementary data. Aggregate dilution of less than 3% generally should be reported when it is anticipated that earnings per share data for a period when the provision applies
17 might subsequently be included in a comparative income statement in which the following period reflects dilution of 3% or more. Otherwise, dilution in the following period would appear greater than it in fact was.

fn.2 The Board intended the 3% provision to provide relief from complex computations to corporations which would have insignificant dilution if all obligations to issue common stock in the future were fulfilled currently. This would be the case, for example, for a corporation which has no obligations to issue common stock except for a small amount of stock under options granted to its executives.

12. 3% Test

Q—Is there a simple test which can be applied to determine if dilution would be at least 3%?

A—Yes. As a "rule of thumb," make both the primary and fully diluted computations whenever the number of additional common shares which must be assumed to be issued exceeds 3%[16] of the

[16]Actually, the number of additional shares must be at least 3/97 (or 3.09+%) of the number of outstanding common shares. If earnings applicable to common stock includes an "if converted" adjustment, a greater number of additional shares would be required to produce dilution of at least 3%. Thus, although the number of additional shares is not the only determinant of dilution, common shares assumed outstanding must increase more than 3% to produce dilution of at least 3%.

number of outstanding common shares. If the dilution produced by 15
either computation is at least 3%, the dual presentation is required.

Dilutive options and warrants are included in earnings per share
computations under the treasury stock method, which produces 36
incremental shares (as explained in Interpretation 51). The number of incremental shares the treasury stock method will produce can be approximated by applying a simple formula. Since stock options are the only obligations of many closely held corporations to issue common stock, the formula is useful when the test described above is to be applied and only options or warrants are considered.

The following formula[17] will approximate the number of incremental shares which will result from applying the treasury stock method for options or warrants:

$$I = \frac{M - E}{M}(N)$$

Where:

- I is the number of incremental shares which would be produced by the treasury stock method.
- M is the market price (or fair value) per share of common stock.
- E is the exercise price of the option or warrant per common share obtainable upon exercise.
- N is the total number of shares obtainable on exercise.

Subject to the constraint[18] that $M > E$

An example of the application of the formula follows. Assume that a corporation has granted options to its officers to purchase 10,000 shares of common stock at \$6 per share and the common stock has a market price (or fair value) of \$10 per share.

Applying the formula for the information given, the amounts to be substituted for the letters are:

I = unknown
M = \$10
E = \$6
N = 10,000

[17]The formula should not be used when Opinion paragraph 38 applies, i.e., when the number of common shares obtainable on the exercise of all options and warrants and their equivalents exceeds 20% of the number of common shares outstanding.

[18]The formula would not be used unless the market price is greater than the exercise price since the result could be anti-dilutive.

Therefore:

$$I = \frac{\$10 - \$6}{\$10} (10{,}000)$$

$$I = .4\ (10{,}000)$$

$$I = 4{,}000$$

If the 4,000 incremental shares exceeds 3% of the number of outstanding common shares, actual dilution would be computed to determine if dilution is at least 3%.

13. Subchapter S Corporations

Q—Does the Opinion apply to the financial statements of corporations electing under Subchapter S of Chapter 1 of the *Internal Revenue Code?*

5, 6 A—Yes, such corporations must report earnings per share on the face of their income statements. Net income is computed without regard to taxes on that income which will be paid by stockholders rather than by the corporation. Undistributed earnings of the corporation taxed to the stockholders increase the stockholders' tax bases in the shares they own, but the number of shares outstanding does not increase unless the corporation issues additional shares. The amount per share of income tax the corporation would have paid in the absence of the Subchapter S election would be useful information to disclose.

14. Unaudited Financial Statements

Q—Does the Opinion apply to unaudited financial statements?

5, 6 A—Yes. If a CPA is associated with an unaudited income statement which does not report earnings per share, the CPA should phrase his disclaimer of opinion on the statement in accordance with the provisions of either paragraph 5 or 6 of Statements on Auditing Procedure No. 38 or paragraph 6 of Statements on Auditing Procedure No. 42 as is appropriate under the circumstances of the engagement.

EARNINGS PER SHARE PRESENTATION

15. Reporting Loss per Share

Q—Must net loss per share be reported?

12 A—Yes, net loss per share must be reported under the same requirements that earnings per share must be reported. Net loss per

share, however, is based on outstanding common shares. Assuming exercise of options and warrants or conversion of convertible securities would be anti-dilutive since an increase in the number of shares assumed to be outstanding would reduce the amount of the loss per share.[19] The amount of the loss is increased by any dividends declared 50
(or cumulative even though not declared) for the period on preferred stocks.

16. EPS for Extraordinary Items

Q—Must earnings per share be presented for extraordinary items?

A—No, although this presentation may generally be desirable. 13
Paragraph 13 of APB Opinion No. 15 states that earnings per share data should be reported consistent with the income statement presentation required by paragraph 20 of APB Opinion No. 9. Thus, it would appear that earnings per share should be presented for (1) income before extraordinary items, (2) extraordinary items less applicable income tax, and (3) net income as required by APB Opinion No. 9 when an extraordinary item is reported on the income statement. This presentation is used in the example in Exhibit B of Appendix C Exh. B
of APB Opinion No. 15.

However, paragraph 13 of APB Opinion No. 15 requires that earnings per share data be presented for only (1) income before extraordinary items and (2) net income. Although the two requirements appear to conflict, earnings per share need not be presented for extraordinary items. A reader of the financial statements can determine earnings per share for extraordinary items by subtraction if it is not reported.

Naturally, the earnings per share data will be more complete if an amount is reported for extraordinary items when such items are reported on the income statement. This presentation, although not required, may therefore be generally desirable. In some cases, reporting all three earnings per share amounts would be particularly helpful to the reader, such as in the situation described in Opinion footnote 8 fn. 8
(where the effect on either income before extraordinary items or on net income is anti-dilutive but is dilutive on the other).

17. Simple Capital Structure

Q—What is a simple capital structure for purposes of computing earnings per share?

[19]See footnote 5 in Part I.

14 A—A corporation has a simple capital structure for purposes of computing earnings per share if during the period it had no securities outstanding (or agreements to issue securities) that in the aggregate dilute earnings per outstanding common share.

18. Complex Capital Structure

Q—What is a complex capital structure for purposes of computing earnings per share?

15 A—A corporation has a complex capital structure for purposes
of computing earnings per share if it has issued, in addition to common
stock, securities which have a dilutive effect on earnings per outstand-
27, 41 ing common share. Among the securities which may have a dilutive
effect are convertible preferred stock, convertible debt, options, war-
rants, participating securities, different classes of common stock, and
agreements to issue such securities or shares of common stock in the
future.

fn.2 As explained in Interpretation 11, if the aggregate dilution for the
period produced by all such securities which are dilutive does not
reduce earnings per outstanding common share by at least 3%, a
14 corporation may be considered as having a simple capital structure
for purposes of computing earnings per share. It may be desirable,
however, to report the actual dilution in such a case, particularly if
17 the period being reported upon might later be included in a compara-
tive income statement which includes one or more periods with
dilution of 3% or more.

19. EPS for Simple and Complex Capital Structures

Q—How does the reporting of earnings per share data differ for corporations with simple capital structures and corporations with complex capital structures?

A—A corporation with a simple capital structure is required to
14 have a single presentation of "earnings per common share" on the
face of its income statement. A corporation with a complex capital
15 structure is required to have a dual presentation of both primary and
fully diluted earnings per share on the face of its income statement.

Exceptions which apply to corporations with simple capital structures are explained in Interpretation 20. An exception which applies to corporations with complex capital structures is explained in Interpretation 18.

20. Dual Presentation for Corporation with Simple Capital Structure

Q—Is a corporation with a simple capital structure ever required to have the dual presentation?

A—Yes, the dual presentation is required if common stock was
issued during the period on exercise, conversion, etc. and primary 41
earnings per share would have increased or decreased if the issuance
had taken place at the beginning of the period.

A corporation has a simple capital structure when it has no 14
dilutive securities outstanding. If outstanding anti-dilutive securities
are exercised or converted, however, such a corporation would be
required to have the dual presentation if primary earnings per share
would have been affected as described above. Thus the dual presenta- 41
tion may be required for a corporation with a simple capital structure
to report the incremental effect of an anti-dilutive exercise or con-
version.

Also, the dual presentation is required for all periods presented 17
in a comparative income statement if it is required for any period.
The dual presentation may therefore be required for one or more
periods in a comparative income statement when the corporation had
a simple capital structure.

21. Primary vs. Fully Diluted EPS

Q—How do fully diluted earnings per share differ from primary earnings per share?

A—Primary earnings per share computations include only com- 24
mon stock and dilutive common stock equivalents. Fully diluted
earnings per share computations include common stock and dilutive
common stock equivalents together with other potentially dilutive
securities. Fully diluted earnings per share also include those exercises 41
or conversions for which common stock was issued during the period
whether their effect is dilutive or anti-dilutive.

Fully diluted earnings per share show the maximum potential 40
dilution of all dilutive contractual obligations to issue common stock
and their effect on current earnings per share on a prospective basis.
The difference between primary and fully diluted earnings per share 16
shows (1) the maximum extent of potential dilution of current earnings
which would occur from the conversions of securities that are not

common stock equivalents or the contingent issuance of common stock not included in the computation of primary earnings per share and
41 (2) the effect of all issuances of common stock on exercises or conversions during the year as if the issuance had occurred at the beginning of the year.

22. Captions for Earnings per Share Presentations

Q—What captions should be used for reporting earnings per share amounts in the dual presentation?

16 A—Precise designations are not prescribed by the Opinion except that the term "earnings per common share" should not be used unless a corporation has a simple capital structure or the term is appropriately qualified. The qualification is determined by whether the corporation has only common stock equivalents or also has other potentially dilutive securities.

Listed below are five captions which might be used to designate earnings per share amounts. Following the captions is a table indicating the captions a corporation might use when it has various combinations of securities outstanding. The first two columns of the table indicate the combinations of securities a corporation might have. The numbers in the other three columns refer to the numbers listed beside the captions which might be used to designate the earnings per share amounts. For example, a corporation having both dilutive common stock equivalents and other potentially dilutive securities outstanding could designate the primary amounts "Earnings per common and common equivalent share" and could designate the fully diluted amounts "Earnings per common share—assuming full dilution."

SUGGESTED EARNINGS PER SHARE CAPTIONS

1. Earnings per common share.
2. Earnings per common share—assuming no dilution.
3. Earnings per common share—assuming full dilution.
4. Earnings per common and common equivalent share. (If both dilutive and anti-dilutive common stock equivalents are present, the caption may be: Earnings per common and dilutive common equivalent share.)
5. Earnings per common share—assuming issuance of all dilutive contingent shares.

TABLE INDICATING USE OF EPS CAPTIONS

			Dual Presentation	
Common Stock Equivalents Present	*Other Potentially Dilutive Securities Present*	*Caption for Single Presentation*	*Primary Caption*	*Fully Diluted Caption*
No[a]	No[a]	1		
No[a]	Dilutive		2	3
No[a]	Anti-dilutive	1[b]		
Dilutive	No		4	3[c]
Dilutive	Dilutive		4	3
Dilutive	Anti-dilutive		4	5[b, c]
Anti-dilutive	No[a]	1[b]		
Anti-dilutive	Dilutive		2[b]	5[b]
Anti-dilutive	Anti-dilutive	1[b]		

Notes:

[a] Or dilution is less than 3% if such securities are present.
[b] In a note, disclose the existence of the anti-dilutive securities.
[c] Primary and fully diluted amounts will be the same.

23. Captions in Comparative Statements

Q—What presentation is required in a comparative income statement when a corporation has a simple capital structure in one period and a complex capital structure in another period?

A—The dual presentation is required for all periods presented if 17
it is required for any period presented. Since the corporation had a complex capital structure in one period presented, the dual presentation is required for that period and for all other periods presented in the comparative income statement.

In a comparative income statement the captions used should be appropriate for the most dilutive presentation. For example, if there were no common stock equivalents in one period, anti-dilutive common stock equivalents in one period, and dilutive common stock equivalents in another period in a comparative income statement, the primary amounts could have a designation such as "earnings per common and dilutive common equivalent share." Explanatory disclosure in a note may also be appropriate.

COMPUTING EARNINGS PER SHARE

24. Earnings Applicable to Common Stock

Q—How is "earnings applicable to common stock" determined for earnings per share computations?

A—For a corporation with a simple capital structure, earnings
50 applicable to common stock is net income reduced by dividends
declared or paid for the period to preferred stock. Cumulative pre-
ferred dividends for the current period not paid or declared also are
deducted from net income in determining earnings applicable to
common stock. However, preferred dividends which are cumulative
only if earned are deducted only to the extent they are earned. Interest
on debt need not be adjusted in determining earnings applicable
to common stock since it was deducted in arriving at net income.

For example, assume that a corporation has a net income of
$6,000 and has 1,000 shares of common stock outstanding. Also
outstanding are 1,000 shares of nonconvertible noncumulative pre-
ferred stock and $10,000 of 6% nonconvertible bonds. The corpora-
14 tion has a simple capital structure. If no dividends were paid on
preferred stock, earnings applicable to common stock would be
$6,000. Earnings per common share would be $6 per share ($6,000
net income divided by 1,000 common shares). The declaration of a
50 dividend of $1 per share on preferred stock would result in earnings
applicable to common stock of $5,000 ($6,000 net income less $1,000
for preferred dividends) and earnings per common share of $5 per
share. The same result would be obtained if the dividend were
cumulative and had not been declared. The same result would also
be obtained whether or not the corporation paid (or declared) a
dividend on common stock.

For a corporation with a complex capital structure, net income is
reduced by dividends on nonconvertible preferred stock as described
51 above. When the if converted method is applied for outstanding
convertible securities, however, dividends for convertible preferred
stock are not deducted from net income but other adjustments may
be necessary. Under the if converted method, convertible dividends
are not deducted when conversion is assumed, and interest (less
applicable income tax) is added back to net income when convertible
debt is assumed to be converted.

For example, assume that a corporation has a net income of
$6,000 and has 1,000 shares of common stock outstanding. Also
outstanding are 1,000 shares of common stock equivalent convertible
preferred stock (convertible one common share for each preferred
share) and $10,000 of 6% convertible bonds (convertible three
common shares for each $100 bond) which are not common
15 stock equivalents. The corporation has a complex capital structure.

Assume also that the corporation paid a $1 per share dividend on both common and preferred stock and the income tax rate is 22%. For primary earnings per share, earnings applicable to common stock 51
is $6,000 and earnings per common and common equivalent share is $3 per share ($6,000 divided by 2,000 shares, composed of 1,000 common shares and 1,000 common equivalent shares from the assumed conversion of the convertible preferred stock). For fully diluted earnings per share, earnings applicable to common stock is $6,468 ($6,000 net income plus $600 interest less $132 additional tax payable if the interest had not reduced net income). Earnings per common share assuming full dilution is $2.81 per share ($6,468 divided by 2,300 shares; composed of 1,000 common shares, 1,000 common equivalent shares, and 300 shares from the assumed conversion of the convertible bonds).

25. Weighted Average of Shares Outstanding

Q—What is the effect on earnings per share computations of issuing common stock or other securities which may be converted or exercised to obtain common stock or of reacquiring common stock or such securities during a period?

A—Such issuances or reacquisitions of common stock or other 47
securities during a period require that a weighted average of shares be computed for the denominator to be used in the earnings per share computations. A weighted average gives due consideration to all shares outstanding and assumed to have been outstanding during a period. Shares issued or retired during a period are weighted by the fraction of the period they were outstanding. The weighted number of shares is added to the number of shares outstanding for the entire period to obtain the weighted average number of shares outstanding during the period.

For example, assume that a corporation had 100,000 common shares outstanding on January 1 and issued 6,000 additional common shares on March 1. The weighted average would be 102,000 shares for the quarter ending March 31 or 104,000 shares for the six months ending June 30 or 105,000 shares for the year ending December 31.

COMPUTATIONAL NOTES:

$$100{,}000 + \tfrac{1}{3}\,(6{,}000) = \mathit{102{,}000}$$
$$100{,}000 + \tfrac{4}{6}\,(6{,}000) = \mathit{104{,}000}$$
$$100{,}000 + \tfrac{10}{12}\,(6{,}000) = \mathit{105{,}000}$$

The same answers would result if the 6,000 shares issued on March 1 were merely assumed to have been issued to reflect the dilutive effect of common stock equivalents issued on March 1. It should be noted that the number of shares in the weighted average for the quarter and for the year are different.

Reacquired shares are included in the weighted average only for the time they were outstanding. For example, assume that a corporation had 100,000 shares outstanding on January 1 and reacquired 6,000 shares on March 1. The weighted average would be 98,000 shares for the quarter ending March 31 or 96,000 shares for the six months ending June 30 or 95,000 shares for the year ending December 31.

COMPUTATIONAL NOTES:

$$100{,}000 - 6{,}000 = 94{,}000$$
$$94{,}000 + {}^{2}/_{3}\ (6{,}000) = \mathit{98{,}000}$$
$$94{,}000 + {}^{2}/_{6}\ (6{,}000) = \mathit{96{,}000}$$
$$94{,}000 + {}^{2}/_{12}\ (6{,}000) = \mathit{95{,}000}$$

The same answers would result if the 100,000 shares had included common stock equivalents and the corporation had reacquired 100 dilutive common stock equivalent convertible bonds (convertible 60 common shares for one bond) on March 1.

More complex methods for computing a weighted average could be used if the number of shares involved changes frequently, such as computing an average weighted by days. (See Exhibit 5, page 114.)

The weighted average discussed in the Opinion and in these Interpretations is technically an arithmetical mean average of shares outstanding and assumed to be outstanding for earnings per share 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 illustrated above, if they produce reasonable results. But methods which introduce artificial weighting are not acceptable for computing a weighted average of shares for earnings per share computations. For example, the "Rule of 78" method, which weights shares for the first month of the year by 12 and weights shares for the last month of the year by 1, is not an acceptable method.

Retroactive recognition is given for all periods presented to any stock dividend, stock split or reverse split, including those occurring after the end of the period for which the computation is being made but before the statements are issued.

CONVERTIBLE SECURITIES

26. Classification and Assumed Conversion

Q—Which convertible securities are assumed to be converted for primary earnings per share computations and which are assumed to be converted for fully diluted earnings per share computations?

A—Convertible securities which are classified as common stock 15, 31
equivalents are assumed to be converted for both primary and fully diluted earnings per share computations. Convertible securities which are not common stock equivalents are classified as other potentially dilutive securities and are assumed to be converted only for fully diluted earnings per share computations.

Conversion is assumed for either computation only when the 30, 40
result is dilutive unless (1) the security is included in an aggregate 38
computation which has a net dilutive effect or (2) for fully diluted
earnings per share, common stock was issued during the period on an 41
anti-dilutive conversion, that is, a conversion which would have had the effect of increasing earnings per share if it had occurred at
the beginning of the period. When conversion is assumed, the if 51
converted method is applied.[20] When conversion is not assumed be-
cause the result would be anti-dilutive, interest or dividends on the 50
securities reduce the amount of earnings or increase the amount of loss otherwise applicable to common stock.

Most convertible securities are classified on the basis of their yield 33
at time of issuance. (The exceptions are discussed in the following paragraphs of this Interpretation.) Under the yield test, convertible securities which yield less than 66⅔% of the bank prime interest rate at time of issuance are common stock equivalents; those yielding at least 66⅔% of the prime rate are other potentially dilutive securities.

If a convertible security has a change scheduled in its interest or dividend rate within five years after issuance, its yield at issuance is considered to be the lowest scheduled rate within the five years. (See Interpretation 28 for the treatment of convertible securities which are

[20]See page 8 of Part I of this Interpretation and Opinion paragraph 51 for a description of the if converted method.

not convertible until a future date.) A convertible security which
would not otherwise be a common stock equivalent at time of issuance
28 is classified as a common stock equivalent if it is issued with the same
terms as those of an outstanding convertible security which is a
common stock equivalent.

46 Convertible securities issued prior to June 1, 1969 are classified by the issuer under one of two alternative elections specified in paragraph 46 of APB Opinion No. 15. (The election made applies to all securities issued before that date, not just to convertible securities.) Under election "a," all convertible securities issued prior to June 1, 1969 are classified as either common stock equivalents or other potentially dilutive securities under the provisions of APB Opinion No. 15. Under election "b," all convertible securities issued prior to June 1, 1969 which were classified as residual securities under APB Opinion No. 9 are classified as common stock equivalents; those which were classified as nonresidual securities are classified as other potentially dilutive securities.

35, 37 Convertible securities which require or permit the payment of cash
upon conversion are considered the equivalents of warrants and are
classified as common stock equivalents. (See Interpretation 71 for the
59 treatment of such securities.) A few convertible participating securi-
ties are common stock equivalents for which the two-class method may
be applied. (See Interpretation 87 for the treatment of such securities.)
51 The if converted method is applied when any convertible security is
assumed to be converted except for unusual cases when the two-class
method is applied.

27. Time of Issuance

Q—What is the "time of issuance" of a convertible security?

29 A—"Time of issuance" is *generally* the date when agreement as to terms has been reached and announced even though subject to further actions, such as directors' or stockholders' approval. In this context, time of issuance is often referred to in financial jargon as the "handshake" date. Thus, time of issuance will usually precede the actual date of issuance of a security by some period which might be as long as several months or as short as a few hours.

"Agreement as to terms" means that all of the terms have been set, not merely that the parties have reached an agreement in principle but the number of securities to be issued or the issue price is still to be determined at a later date. Agreement as to terms is reached when the parties are obligated to complete the transaction if it is ratified by the directors and/or stockholders, that is, neither party may legally terminate the agreement except for failure to receive approval from the directors or stockholders. The fact that the agreement is subject to a "favorable" ruling from the Treasury Department or a regulatory agency does not affect time of issuance so long as all of the terms of the agreement have been set.

The classification of a convertible security is determined at time of issuance and does not change when the security is actually issued except as discussed in Interpretation 29.

When time of issuance occurs before a year end but the agreement has not been approved by either the directors or stockholders before the financial statements are issued, the securities are not considered outstanding in the financial statements being issued or in earnings per
share computations. (The securities are similar to a contingent issu- 62
ance whose conditions are not currently being met.)

28. Classification and Computation Not Always the Same

Q—Are convertible securities included in earnings per share computations at time of issuance?

A—Convertible securities are classified at time of issuance. Gen- 28
erally they are assumed to be converted for earnings per share compu-
tations from this date also. Although a convertible security is classified 51
at time of issuance, in some cases it is not assumed to be converted for earnings per share computations until a later date.

If the conversion privilege is not effective during the period being reported upon, the length of time before the privilege becomes effective determines when the security is eligible for assumed conversion in
earnings per share computations. Conversion is not assumed for either 58
primary or fully diluted computations if the conversion privilege is not effective within ten years from the end of the period being reported upon. Conversion is assumed only for fully diluted computations if the conversion privilege is effective after five years but within ten years from the end of the period being reported upon. Conversion is assumed as if the security were immediately convertible if the conver-
sion privilege is effective within five years from the end of the period 57
being reported upon.

For example, assume that a corporation issued a debt security at the end of its 1969 reporting year that may be converted into common stock after twelve years (at the end of 1981). The security's yield at time of issuance requires that it be classified as a common stock equivalent. Conversion would not be assumed for 1969 or 1970 earnings per share computations (interest would reduce net income in 1970, however). Conversion would be assumed whenever the effect is dilutive for fully diluted computations beginning in 1971 and for both primary and fully diluted computations beginning in 1976. Thus, the
28 security is classified at time of issuance but conversion is not assumed for earnings per share computations until later.

Time of issuance and classification of a convertible security may precede the obligation to issue and actual issuance by as much as several months, but a convertible security is not considered outstanding in the interim until there is a valid obligation to issue the security. For example, assume that agreement as to terms for a business combination is reached and announced on December 1, 1969. Final approval by stockholders occurs on February 16, 1970 and a convertible security is to be issued March 2, 1970. Classification of the security is determined at December 1, 1969. The security would be omitted from 1969 earnings per share computations if the financial statements are issued before February 16, 1970, but the impending issuance would be disclosed.

49 If the business combination is accounted for as a purchase, the security would be considered outstanding from the date of the acquisition in 1970 earnings per share computations if the stockholders in fact ratify the agreement. If the business combination is accounted for as a pooling of interests, prior periods' earnings per share data would be retroactively restated in comparative income statements issued subsequently to reflect the security as outstanding for all periods presented. (See Part I, page 12.)

29. Change of Classification of Convertible Security

Q—When does the classification of a convertible security change?

A—A convertible security's classification is generally determined
28 only at time of issuance and does not change thereafter. However, a change of classification (usually from other potentially dilutive security status to common stock equivalent status) may be required in two
29 situations. These are when (1) an incorrect estimate of the security's value at time of issuance was made in the absence of a market price

or (2) a common stock equivalent convertible security is issued with
the same terms as an already outstanding convertible security which 28
is not a common stock equivalent. (See Interpretation 30.)

If a convertible security does not have a market price at time of
issuance, an estimate must be made of the security's fair value to apply fn. 9
the yield test. If the estimate of the security's value is too low, a con-
vertible security which should be classified as a common stock equiva-
lent might not be so classified. In such a case, the security would have
to be reclassified as a common stock equivalent at actual issuance. 29
Typically, an obviously incorrect estimate would be evidenced by
materially higher market transactions for the security at actual issuance
shortly after the time of issuance.

A change of the classification of the security would not be appropriate in such a case, however, if the higher market prices resulted from an external change over which the issuer had no control. (A general increase in the market prices of other securities might indicate an external change.) A change of the classification would also not be appropriate if convertible securities were sold for cash and the gross proceeds to the issuer were substantially equal to the total amount of the original fair value estimate for the securities. In this case, the total of the net amount received by the issuer plus brokerage commissions paid is approximately equal to the original estimate of fair value of the securities.

30. Change of Classification Is Mandatory

Q—Would convertible securities issued prior to June 1, 1969 and
classified as other potentially dilutive securities under Opinion para-
graph 46 become common stock equivalents if another convertible 46
security is issued with the same terms after May 31, 1969 and is classi-
fied as a common stock equivalent?

A—Yes, a change in classification is required by the second sen- 28
tence of Opinion paragraph 28 for any outstanding convertible secur-
ity which is not a common stock equivalent but which has the same
terms as those of another convertible security being issued which is
classified as a common stock equivalent at time of issuance. Thus, an
outstanding convertible security which is not a common stock equiva-
lent would be reclassified as a common stock equivalent if another
convertible security is issued with the same terms and is classified as a
common stock equivalent at time of issuance.

Although this reclassification is an exception to the general rule that securities do not change status subsequent to time of issuance, reclassification is mandatory. All of a corporation's convertible securities issued with the same terms therefore are classified the same for earnings per share computations.

For example, assume that convertible securities were issued with the same terms on May 2, June 2, and July 2, 1969. Only the July 2 issue is a common stock equivalent if classification is based on yield at time of issuance because of an increase in the bank prime interest rate. Under Opinion paragraph 28, however, both the May 2 and June 2 issues become common stock equivalents also.

31. Definition of "Same Terms"

Q—What are the "same terms" (as used in the second sentence of Opinion paragraph 28) for the subsequent issuance of a convertible security?

28 A—The "same terms" are identical terms, not merely similar terms. Thus, any change in dividend or interest rates, conversion rates, call prices or dates, preferences in liquidation, etc. is a change in terms. Market price or issue price is not considered a "term." (See Interpretation 32.)

32. Issue Price Is Not a "Term"

Q—Do different issue prices for different issuances of convertible securities constitute a change in "terms" if all other terms for the securities are the same?

A—No, different issue prices for convertible securities with the
28 same terms otherwise is not a change in terms. Thus, two convertible securities issued at different prices but with the same stated dividend or interest rates, conversion rates, call prices and dates, preferences in liquidation, etc. have the same terms.

33. Sale of Treasury Securities Is a New Issue

Q—Are convertible securities sold by an issuer from securities held as treasury securities to be classified as a new issue or as part of the original issue under the provisions of the second sentence of Opinion paragraph 28?

A—When convertible securities are acquired by the issuing corporation and subsequently reissued, they constitute a new issue with

the same terms as the existing outstanding convertible security. The 28
"new" issue's status (as a common stock equivalent or not) should be determined under both the common stock equivalent test and the provisions of the second sentence of Opinion paragraph 28. If deemed a common stock equivalent, the "new" issue could also affect the status of outstanding securities with the same terms as described in the second sentence of Opinion paragraph 28. For example, if the outstanding securities are not common stock equivalents and the reissued securities are common stock equivalents under the yield test (because of a change in market prices or the prime rate), the outstanding securities also become common stock equivalents.

34. Determining a Convertible Security's Cash Yield

Q—Upon what return is a convertible security's cash yield based?

A—Cash yield for most convertible securities is based upon the 33
stated amount of interest or dividends the security is scheduled to pay each year.[21] However, if the dividends on convertible preferred stock are not cumulative, yield might have to be based on some lesser amount, particularly if the stated amount appears impossible to pay. Low earnings or contractual provisions on outstanding debt, for example, might prohibit payment of the stated amount. The same would apply for preferred dividends which are cumulative only if earned.

35. Computing a Convertible's Cash Yield

Q—How is a convertible security's cash yield at time of issuance computed?

A—Yield is a security's return expressed as a percentage of its 33
value. For example, a $1,000 bond which is paying $45 annual interest to the holder and selling at 90 (i.e., $900) yields 5% $\left(\text{computed } \frac{\$45}{\$900} \times 100\right)$ if the time factor to maturity is ignored. Although yield is generally computed to maturity, the yield test described in the Opinion for convertible securities uses only the stated annual return expressed as a percentage of the security's market price (ignoring commissions and transfer taxes) at time of issuance. If the security does not have a market price at time of issuance, the test is based on the security's fair value.

[21]See Interpretation 26 for the amount to be used when a convertible security has a change of interest or dividends scheduled.

36. Cash Yield of Convertible Security in a "Package"

Q—How is the cash yield determined for a convertible security issued in a "package," i.e., a convertible security is one of two or more securities issued as a unit?

A—When two or more securities are issued as a unit, the unit price at time of issuance should be allocated to each security based on
fn. 9* the relative fair values of the securities at time of issuance. For example, assume that a "package" consisting of one share of common stock, one share of convertible preferred stock, and one nonconvertible $100 bond with a detachable warrant is sold as a unit for a total price of $200. At time of issuance, fair values were $42 per share of common stock, $63 per share of convertible preferred stock, $99.75 per bond and $5.25 per warrant. The $200 unit amount would be allocated to each security as follows:

	Fair Value at Issuance	*Percentage of Total*	*Allocated Amount of $200*
Common stock	$ 42.00	20.0%	$ 40.00
Preferred stock	63.00	30.0	60.00
Bond	99.75	47.5	95.00
Warrant	5.25	2.5	5.00
Totals	$210.00	100.0%	$200.00

If the convertible preferred stock is scheduled to pay a dividend of $3.15 per share each year, it would yield 5.25%

$$\left(\text{computed } \frac{\$3.15}{\$60.00} \times 100\right).$$

37. Property Included in Cash Yield

Q—May the fair value of property to be paid as dividends or interest be included in computing cash yield since the Opinion specifically states only "cash"?

33 A—Yes, the fair value of property to be paid in lieu of cash may be included in computing the cash yield of a convertible security. The property so treated may include nonconvertible senior securities of the same company. But it may not include the same issue for which common stock equivalency is being determined. And it may not include securities of the issuer or its parent or subsidiary which are currently or potentially dilutive and enter into the computation of either primary or fully diluted earnings per share.

* Also see APB Opinion No. 14.

For example, any common stock or common stock equivalent of the issuer and securities such as those described in Opinion paragraphs 59, 60, and 65-69 would not be considered property for this purpose. Also, "extra" dividends to be paid on convertible stock on a non-recurring basis would not be considered in computing cash yield in conformity with the "lowest scheduled rate" provision of Opinion paragraph 33.

38. Prime Rate Used in Yield Test

Q—What bank prime interest rate should be used to determine the status of a convertible security as a common stock equivalent or not in applying the yield test when more than one rate is in effect in a country?

A—The prime interest rate in effect at the bank where the issuer 34
borrows is used when more than one bank prime interest rate (or its equivalent in foreign[22] countries) is in effect in the U.S. If the issuer borrows from more than one bank and the different banks have different prime rates in effect, an average of the rates is used. If the issuer does not borrow from a bank where the prime interest rate is offered and more than one bank prime interest rate is in effect, an average of the rates would be used unless the issuer can show that the predominant rate is more appropriate than an average rate.

39. Prior Period Prime Rates

Q—What source should be considered authoritative in determining the bank prime interest rate which was in effect in the U.S. during prior periods when applying election "a" of Opinion paragraph 46? 46

A—The *Federal Reserve Bulletin* may be considered an authoritative source for determining the bank prime interest rate at any time. 34
When a "split" prime rate is in effect, the provisions of Interpretation 38 are applied. For readers' convenience, the dates of changes in the prime rate and the rates in effect from 1954 through 1970 have been extracted and appear in Exhibit 2, page 108.

40. Original Issue Premium or Discount on Convertible Securities

Q—What happens to original issue premium or discount when convertible securities are assumed to be converted and common stock is assumed to be issued for earnings per share computations?

[22]See *The Banker,* February 1969, p. 117 *ff.*, for a discussion of rates in foreign countries which are the equivalents of the U.S. bank prime interest rate.

51 A—Any original issue premium or discount amortized during the period (to compute the effective interest deducted from net income for a debt security) is eliminated from net income in arriving at earnings applicable to common stock. The unamortized original issue premium or discount balance at the date of assumed conversion (the ending balance plus the amount amortized during the period) is then ignored for earnings per share computations. The if converted method only assumes conversion of the securities; it does not assume retirement. The converted securities are assumed to be held by the issuer as treasury securities during the period being reported upon and balance sheet accounts related to those securities are not affected by the assumed conversion. Note that these assumptions are made only for earnings per share computations; the issuer's balance sheet and net income for
39 the period are not affected in any way by the assumptions made for earnings per share computations.

41. No Anti-Dilution From Convertible Preferred Stock

Q—When is convertible preferred stock anti-dilutive and therefore not assumed to be converted for earnings per share computations?

30, 40 A—Convertible preferred stock is anti-dilutive and conversion is
50 not assumed[23] whenever the amount of the dividend paid or declared for the current period (or accumulated if not paid) per common share obtainable upon conversion exceeds the earnings per share amount computed without assuming conversion.

For example, assume that a corporation had a net income of \$1,500 and had 1,000 shares of common stock outstanding. Also outstanding were 1,000 shares of preferred stock convertible on a one-for-one basis and classified as a common stock equivalent. A \$1 per share dividend was paid to the convertible shareholders. Assumption of conversion would be anti-dilutive in this case since earnings per outstanding common share is \$.50 per share. (Earnings per common and common equivalent share would be \$.75 per share if conversion were assumed.) Conversion would not be assumed, but rather the preferred dividend would be deducted to compute earnings applicable to common stock. Earnings per share would be computed on the basis of actual common stock outstanding. The same result would be obtained if the dividend were cumulative and not paid.

[23]See Interpretation 44 for an exception when actual conversion occurs.

42. No Anti-Dilution from Convertible Debt

Q—When is convertible debt anti-dilutive and therefore not assumed to be converted for earnings per share computations?

A—Convertible debt is anti-dilutive and conversion is not as- 30, 40
sumed[24] whenever its interest (net of tax) per common share obtainable 50
on conversion exceeds the earnings per share computed without assuming conversion.

For example, assume that a corporation had a net income of $500 and had 1,000 shares of common stock outstanding. Also outstanding were 1,000 convertible bonds with a par value of $100 each paying interest at 3% per annum and convertible into one share of common stock each. Assume the bonds are classified as common stock equivalents and that the effective income tax rate is 50%. The earnings per common share outstanding (ignoring conversion of the bonds) is $.50 per share. Assuming conversion, $3,000 interest would be added back less $1,500 of additional income tax, resulting in a net increase of $1,500 and earnings applicable to common stock of $2,000. The $1.00 earnings per share for the 2,000 common and common equivalent shares would be anti-dilutive and conversion would therefore not be assumed.

43. Conversion Assumed for Primary Only

Q—When a common stock equivalent convertible security is assumed to be converted for primary earnings per share computations, must it also be assumed to be converted for fully diluted earnings per share computations?

A—Generally, a common stock equivalent convertible security is 15, 31
assumed to be converted for both computations. However, if fully
diluted earnings per share would be increased by the assumed con- 40
version, conversion would be assumed only for the primary earnings per share computation. Such a situation could occur if two convertible securities were outstanding and the dividend on one classified as a common stock equivalent exceeds fully diluted earnings per share but not primary earnings per share.

For example, assume that a corporation had a net income of $9,500 and had 2,000 shares of common stock outstanding. Also outstanding were 1,000 shares of Class A convertible preferred stock which was a common stock equivalent and 1,500 shares of Class B

[24]See Interpretation 44 for an exception when actual conversion occurs.

convertible preferred stock which was not a common stock equivalent. The Class A paid a dividend of $2.50 per share and the Class B paid a dividend of $1 per share. Both are convertible into common on a one-for-one basis.

Primary earnings per share is $2.67 per share assuming conversion of the Class A convertible preferred ($9,500 – $1,500 = $8,000 earnings applicable to common divided by 3,000 shares). Fully diluted earnings per share would be $2.11 per share if conversion were assumed for both the Class A and Class B convertible preferred ($9,500 ÷ 4,500 shares). However, fully diluted earnings per share is $2.00 per share if conversion is assumed for only the Class B ($9,500 – $2,500 = $7,000 earnings applicable to common divided by 3,500 shares). The difference between $2.11 and $2.00 is caused by the incremental effect of assuming conversion of the Class A. Since the Class A dividend per common share obtainable upon conversion exceeds fully diluted earnings per share computed without assuming conversion, conversion would be anti-dilutive. (See Interpretation 41). Therefore, primary earnings per share is reported at $2.67 per share and fully diluted earnings per share is reported at $2.00 per share since this is the maximum dilutive amount.

This example illustrates the fact that earnings per share amounts may be affected by changes either in the numerator or in the denominator used in the computation. Naturally, in some cases, both change.

44. If Converted Method at Actual Conversion

Q—Is the if converted method applied differently for primary and fully diluted earnings per share computations when actual conversion occurs?

41 A—When a common stock equivalent convertible security is converted during a period, the if converted method is applied from the beginning of the period[25] to the date of conversion for both primary and fully diluted earnings per share computations if the result is dilutive.

30 If the result is anti-dilutive, however, conversion is not assumed
41 for the primary computation. But when an actual conversion occurs during a period, conversion is assumed at the beginning [25] of the period

[25]For convertible securities issued and converted during the period, conversion is assumed only from time of issuance rather than from the beginning of the period.

for the fully diluted computation and the if converted method is applied, regardless of whether the result is dilutive or anti-dilutive.

Upon actual conversion, common stock issued is included in the 47
weighted average of shares outstanding in both the primary and fully diluted computations from the date of conversion. The securities tendered by the holder for conversion are thereafter considered to be retired.

45. Securities Convertible into Other Convertible Securities

Q—How is a convertible security which is convertible into another convertible security included in earnings per share computations?

A—Such convertible securities enter earnings per share computa- 43
tions according to their provisions and their characteristics.

A convertible security issued by a subsidiary which is convertible only into a parent company's convertible security is a senior security from the standpoint of the subsidiary, i.e., the yield test does not apply. For consolidated earnings per share computations, however, the subsidiary's security would be assumed to be converted into the parent's security. The parent's security would then be assumed to be converted under the if converted method (if the net result is dilutive). If the parent's convertible security is not a common stock equivalent, conversion of the parent's security would be assumed only for fully diluted computations. If it is a common stock equivalent, conversion of the parent's security would be assumed for both primary and fully diluted computations. (See Interpretation 93.)

Convertible securities which are convertible at the option of the holder into either another convertible security or a nonconvertible security are assumed to be converted into the security which would
be more advantageous for the holder (but not if the result is anti- 56, 58
dilutive). If conversion is assumed into the other convertible security, that security is then assumed to be converted into common stock for earnings per share computations (but not if the net result is anti-dilutive). If conversion is assumed into the nonconvertible security, dividends which would have been applicable to the nonconvertible security, as if it had been outstanding, are deducted in determining earnings applicable to common stock. If converted adjustments may also be applicable. The classification (determined under the yield test) as a common stock equivalent or other potentially dilutive security of convertible securities which are convertible at the option

of the holder as discussed in this paragraph determines whether conversion is assumed for both primary and fully diluted computations or only for fully diluted computations.

In some cases, the security which would be more advantageous for assumed conversion cannot be determined. This might be the case, for example, if the nonconvertible security pays a high dividend and the second convertible security has good prospects for an increase in its market price. If the more advantageous security to the holders cannot be determined, the computation should give effect to the greater earnings per share dilution.

OPTIONS AND WARRANTS AND THEIR EQUIVALENTS

46. Classification of Options and Warrants

Q—How are options, warrants and their equivalents classified for earnings per share computations?

35 A—Options, warrants and their equivalents are always common
46 stock equivalents unless *all* of the following conditions are met: (1)
they were issued prior to June 1, 1969 *and* (2) the issuer makes election "b" under paragraph 46 of APB Opinion No. 15 *and* (3) they were not classified as residual securities under APB Opinion No. 9. Options, warrants and other equivalents classified under this exception are not common stock equivalents but are other potentially dilutive securities and are included only in fully diluted earnings per share computations.[26] All other options, warrants and their equivalents are
35, 42 included in both primary and fully diluted earnings per share computations.

47. No Anti-Dilution from Options and Warrants

Q—When are options and warrants anti-dilutive under the treasury stock method?

A—Generally, options and warrants are anti-dilutive whenever
36 their exercise price exceeds the market price of the common stock
obtainable on exercise. This is because application of the treasury
fn. 12 stock method in such a case would reduce the number of common
shares included in the computation which would increase the earnings per share amount.

[26]These options and warrants would be common stock equivalents except for the fact that they were issued before APB Opinion No. 15 was released. The Opinion provides that they be classified as common stock equivalents only if the issuer elects to so classify them.

The prohibition against anti-dilution in applying the treasury stock 30, 40
method recognizes the economic fact that an option or warrant would
not be exercised if the exercise price were above the market price
because the stock could be purchased in the market for less than it
could be purchased by exercising the option or warrant. However, if
for some reason options or warrants are exercised when the market
price is below the exercise price, the market price at the exercise date 42
is applied in the fully diluted computation for the exercised options or
warrants for the period they were outstanding. (See Interpretation 62.)
However, anti-dilution is not reflected in the primary computation 30
prior to exercise.

In special cases for which other methods are applied (see Opinion 37, 38
paragraphs 37 and 38), the factors which cause dilution or anti-
dilution are, of course, different. These special cases are discussed in
Interpretations 50 and 65-71.

48. Equivalents of Options and Warrants

Q—What kinds of securities are considered the equivalents of options and warrants and therefore always classified as common stock equivalents?

A—Stock purchase contracts, stock subscriptions not fully paid, 27
deferred compensation plans providing for the issuance of common
stock, and convertible debt and convertible preferred stock allowing 35, 37
or requiring the payment of cash at conversion (regardless of the yield
of such convertible securities at time of issuance) are considered the
equivalents of options or warrants. The treasury stock method should 36
be applied for all of these securities unless their terms or the provisions
of Opinion paragraphs 37 and 38 require that another method be 37, 38
applied for the computation of earnings per share.

49. Grouping Options and Warrants

Q—May anti-dilutive options and warrants be grouped with dilutive options and warrants in applying the treasury stock method?

A—No, except in the special situations discussed below. 30, 40

Footnote 11 of the Opinion allows reasonable grouping of like fn. 11
securities, i.e., options and warrants with the same exercise prices per
common share to be issued. For example, it would be appropriate to
group an option to purchase one share of common stock for $20 with
a warrant to purchase two shares of common stock for $40. Assuming

a market price of $15 per share for common stock, these options and warrants would not be grouped with a warrant to purchase one share of common stock for $10.

38 If an aggregate computation is required, however, anti-dilutive and dilutive securities must be included in the same computation. Opinion paragraph 38 provides for an aggregate computation, for example. An anti-dilutive option which must be exercised before a dilutive option may be exercised must also be included in an aggregate computation.

For example, assume an option is exercisable at $30 to purchase one share of common stock and a second option is exercisable at $10 to purchase one share of common stock *after* the first option is exercised. The two options would be grouped and considered as a "two-step" option to buy two shares of common stock for $40. Their aggregate effect would be dilutive whenever the market price of common stock exceeds $20 per share. An aggregate computation would not be made for a dilutive option which must be exercised before an anti-dilutive option may be exercised, because the anti-dilutive option would not be exercised in such a situation.

50. Methods Used for Options and Warrants

Q—Since different methods are described for the treatment of options and warrants in the Opinion, in what order should the different methods be applied?

36 A—In determining the effect of options and warrants and their equivalents in earnings per share computations, apply Opinion paragraphs in the following order (to the extent that each is pertinent):

Opinion paragraph 37
Opinion paragraph 38
Opinion paragraph 36

35, 37 Opinion paragraph 37 applies to options and warrants or their equivalents (1) which either allow or require the tendering of debt at exercise or (2) whose proceeds from exercise must be applied to retire debt or other securities under the terms of those securities. Opinion paragraph 37 also applies to convertible securities which either allow or permit the payment of cash at conversion. Such convertibles are considered the equivalents of warrants.

38 Opinion paragraph 38 applies only when the number of common shares obtainable upon exercise of all outstanding options and warrants

and their equivalents exceed 20% of the number of common shares outstanding at the end of the period.

Opinion paragraph 36 (the treasury stock method) applies to all other options and warrants and their equivalents. 36

51. Treasury Stock Method Reflects Dilution of Options and Warrants

Q—How does the treasury stock method reflect the dilutive effect of options and warrants?

A—The treasury stock method increases the number of shares assumed to be outstanding when the exercise price of an option or warrant is below the market price of common stock obtainable on exercise. The dilutive effect of the treasury stock method is demonstrated in the following example. **fn. 12**

Assume that a corporation earned $125,000 during a period when it had 60,000 shares of common stock outstanding. The common stock sold at an average market price of $20 per share during the period. Also outstanding were 10,000 warrants which could be exercised to purchase one share of common stock for $15 for each warrant exercised. Earnings per common share *outstanding* would be $2.08 per share ($125,000 ÷ 60,000 shares).

Applying the treasury stock method, the 10,000 warrants would be assumed to have been exercised by their holders at the beginning of the period. Upon exercise, 10,000 shares of common stock would be assumed to have been issued by the corporation to the holders. The $150,000 proceeds (10,000 warrants at an exercise price of $15 per share) would be assumed to have been used by the corporation to purchase 7,500 shares ($150,000 ÷ $20 per share average market price) of common stock in the market on the exercise date. Common stock would therefore increase 2,500 shares.[27] (10,000 shares issued less 7,500 shares purchased results in 2,500 *incremental* shares.) A total of 62,500 shares would be considered as outstanding for the entire period. The amount to be reported as primary earnings per share would be $2.00 per share ($125,000 ÷ 62,500 shares), or dilution of $.08 per share. 36

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[27]The incremental number of shares may be more simply computed $\frac{\$20 - \$15}{\$20} \times 10{,}000 = 2{,}500$ using the formula given in Interpretation 12.

Fully diluted earnings per share would also be $2.00 per share
if the ending market price of the common stock were $20 per share or
42 less. But an ending market price above $20 per share would cause
more dilution to be reflected in fully diluted earnings per share. For example an ending market price of $25 per share would produce 4,000 incremental common shares[28] which would result in fully diluted earnings per share of $1.95 per share. Dilution would be $.13 per share from earnings per outstanding share and $.05 per share from primary earnings per share.

52. Market Prices Used for Treasury Stock Method

Q—What market prices of common stock are used in applying the treasury stock method for options and warrants?

36 A—The average market price of common stock during each
Exh. B three-month quarter included in the period being reported upon is
used to determine the number of incremental shares included in
36 primary earnings per share computations. When a period of less than
three months is being reported upon, the average market price during
that period is used.

42 The average market price during each three-month quarter in-
Exh. B cluded in the period being reported upon is also used to determine
the number of incremental shares included in fully diluted earnings
42 per share computations *unless* (1) the ending market price for the
quarter is higher than the average market price or (2) options or
warrants were exercised during the quarter.

A higher ending market price for the quarter is used in fully diluted computations rather than the average market price. For the fully diluted year-to-date computation, the number of incremental shares produced by applying the ending market price is compared to the number of shares determined by computing a year-to-date weighted average of incremental shares included in the quarterly fully diluted computations. The number of incremental shares used in the fully diluted year-to-date computation is the greater of the number of incremental shares determined from the ending market price or from the weighted average of quarters. (See Interpretation 60 and Exhibit 4 for examples.)

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[28]For fully diluted incremental shares, the compution would be

$$\frac{\$25 - \$15}{\$25} \times 10{,}000 = 4{,}000.$$

When options or warrants are exercised, the market price on the exercise date is applied for the exercised options or warrants from the beginning of the year to the exercise date for fully diluted computations. Thus, the incremental share computations for quarters prior to the exercise date use the market price at the exercise date rather than the ending or average market price. (See Interpretations 61 and 62 for examples.)

In accordance with the anti-dilution provisions of the Opinion, 30, 40
exercise of options or warrants is not assumed for any quarter when
the exercise price is higher than the market price determined for the
computation (as described above) except when options or warrants 42
have in fact been exercised. However, anti-dilutive options or warrants
would be included in an aggregate computation resulting in a net 38
dilutive effect.

Thus, options and warrants may be included in the computations
in some quarters but not in other quarters. Also, options and warrants 30
may be included in fully diluted earnings per share computations in a
quarter when the ending market price is above the exercise price 42
but not included in primary earnings per share computations for the 30
quarter because the average market price is below the exercise price.

53. How Many Market Prices?

Q—How many market prices should be used to determine the average market price of common stock when applying the treasury stock market?

A—As many market prices as are needed to compute a meaningful 36
average would be used.

Theoretically, every market transaction for a company's common stock (both the number of shares and the price per share) could be included in determining the average market price. For example, consider four transactions of: 100 shares at $10 per share, 60 shares at $11 per share, 30 shares at $12 per share, and 10 shares at $13 per share. The average of the four prices would be $11.50 (a simple average) but the average price for the 200 shares would be $10.75 per share (a weighted average).

As a practical matter, however, a simple average of monthly prices is adequate so long as prices do not fluctuate significantly. If prices fluctuate greatly, weekly or daily prices probably would be used. Only if volume of common shares traded and prices at which trades occurred both fluctuated significantly would it be necessary to compute a weighted average to obtain a meaningful average market price.

54. What Market Price to Use?

Q—Should the market price used in computing the average described in Interpretation 53 be the high, low, close or an average of high and low prices?

A—Generally, closing market prices would be adequate for use
36 in computing the average market price. When prices fluctuate widely, however, an average of the high and low prices for the period the price represents (whether a month, week, or day) would usually produce a more representative price to be used.

Perhaps more important than the price selected is that the particular price selected be used consistently unless it is no longer representative because of changed conditions. For example, a company using the closing price during several years of relatively stable market prices could change to an average of high and low prices if prices started fluctuating greatly and the closing market price would no longer produce a representative average market price. Likewise, a company using an average of high and low prices during several years of relatively stable volume could use an average weighted by the number of shares included in market transactions during the period if both prices and volume started fluctuating greatly and the simple average of high and low prices would no longer produce a representative average market price. Shorter periods would be more appropriate than longer periods in this case also, as noted in Interpretation 53.

Changing the price, period or method used in computing the average market price would only be done when it becomes obvious that a representative average market price would not be obtained if the change were not made. In the absence of changed conditions a change would not be made.

55. Over-the-Counter and Listed Stocks Not Traded

Q—What price should be used when applying the treasury stock method for an over-the-counter stock or a listed stock not traded?

36 **A**—If available, market prices at which trades occur would be used in applying the treasury stock method. For stocks traded over-the-counter, the actual trade prices may not be known. Bid and asked

quotations generally are available, however, for both over-the-counter stocks and listed stocks not traded.

The price which will be representative of the market price may have to be computed from the information available. An average of the bid and asked quotations might produce a representative price. In some cases, an average of quotations from several dealers could be used. Generally the method selected would be used consistently in the absence of actual market prices.

It should be noted that although bid quotations produce a conservative estimate of a stock's market value, asked quotations are more conservative for earnings per share computations. This is because a higher market price produces more incremental shares under the treasury stock method than does a lower price. Therefore, to obtain a conservative answer, the asked quotation would be used in applying the treasury stock method for listed common stocks not traded and for common stocks traded over the counter.

56. Fair Value Used If No Market Price

Q—How should the average market price be determined, to apply the treasury stock method for options and warrants, if a company's common stock is not traded (for example, for a closely held company with only options outstanding)?

A—When a company's common stock is not traded and market prices are therefore not available, the fair value per share of its fn. 9
common stock is used to apply the treasury stock method for options and warrants.

Estimating the fair value of a share of common stock which is seldom, if ever, traded is often difficult. Various methods of valuation may be appropriate under different circumstances. While book value or liquidation value per share may provide some indication of fair value, these amounts usually would not be used without adjustment. Estimations based on replacement value or capitalized earnings value, however, might be used in determining fair value.

In some cases documents may be used as a basis for estimating the fair value of a company's common stock. Personal financial statements of stockholders prepared in accordance with *Audits of Personal Financial Statements* (An AICPA Industry Audit Guide published by the American Institute of CPAs in 1968) would present the estimated value of their stock ownership in the company. Buy and sell agreements contain provisions for determining the value of a stockholder's interest in a company in the event of death or retirement or withdrawal from participation in the company's activities. Estate tax valuations established for recently deceased stockholders may provide a basis for estimating the current value of a company's stock. Merger or sales negotiations entered into by the company and valuations or appraisals obtained by a stockholder or the company for credit purposes may provide established values appropriate for use in estimating the fair value of a company's common stock. A fair value estimate of the stock might also be projected currently from the relationship at the time of issuance of the warrant or option to earnings (on a per share basis) or to the book value of the common stock.

External sources may also be used to obtain a fair value estimate for a company's stock. Traded securities of other companies in the same industry, their price-earnings ratios, dividend yields, and the relationship of their market prices to book values per share may provide guidance for estimating the value of a stock which is not traded. In addition to the methods suggested above, articles in professional publications may suggest other valuation methods and provide more specific guidance for applying selected techniques (for example, see *The Journal of Accountancy,* August 1969, pages 35-47, and March 1966, pages 47-55). Revenue Ruling 59-60 also provides guidance for valuing stocks with no quoted market prices. In some instances, companies have engaged investment bankers to estimate the value of the common stock when management believed a fair value could not be obtained any other way.

When a fair value estimate is used in the absence of market prices for a company's common stock, this fact and the method used to
20 estimate the fair value would be disclosed as required by Opinion paragraph 20. The disclosure would usually be contained in a note to the earnings per share amounts presented (such as the example in Exhibit C of Appendix C to the Opinion).

57. Options and Warrants Outstanding Part of a Period

Q—How should dilutive options or warrants which are outstanding for only part of a period be treated for earnings per share computations?

A—Dilutive options or warrants which are issued during a period or which expire or are cancelled during a period are reflected in both primary and fully diluted earnings per share computations for the

time they were outstanding during the period being reported upon. 36, 41
The common equivalent shares to be considered enter earnings per share computations as a weighted average as described in Opinion paragraph 47. 47

For example, assume that a corporation whose financial reporting year ends on December 31 issued 100,000 warrants for one share each on October 8, 1969 with an exercise price of \$10. Assume also an average market price for common stock during the intervening twelve-week period of \$12 per share. Applying the treasury stock method for primary earnings per share computations for the fourth quarter, the 16,667 incremental shares

$$\left(\text{computed } \frac{\$12 - \$10}{\$12} \times 100{,}000 = 16{,}667\right)$$

would be weighted 12/13, since they were outstanding for only twelve of the thirteen weeks during the quarter, and would represent 15,385 common shares (16,667 × 12/13) in the fourth quarter of 1969. In the annual earnings per share computation for 1969, these warrants would represent 3,846 common shares (15,385 ÷ 4).

If the market price at December 31, 1969 for common stock exceeded the \$12 average market price, the higher market price would be used in computing fully diluted earnings per share to reflect maximum potential dilution as specified in Opinion paragraph 42. For a market price of common stock on December 31 of \$12.50 per share, the shares to be added for the fourth quarter fully diluted earnings per share would be computed as follows:

$$\frac{\$12.50 - \$10}{\$12.50} \times 100{,}000 = 20{,}000$$

$$12/13 \times 20{,}000 = \textit{18,462} \text{ shares.}$$

The shares to be added for 1969 annual fully diluted earnings per share in this case would be 4,615.

If the warrants described in the above example expired or were cancelled on March 25, 1970 and we assume an average market price for common stock during the twelve weeks then ended of \$12, the same results as above would be obtained for primary earnings per share computations for the first quarter of 1970. That is, assumed exercise of the 100,000 warrants would produce 16,667 incremental shares weighted 12/13 and would represent 15,385 common shares in the first quarter of 1970. In the annual earnings per share computations for 1970, these warrants would represent 3,846 common shares.

If the market price of common stock on the *last day the warrants were outstanding* (March 25, 1970) exceeded the \$12 average market
42 price for the twelve week period, the higher market price would be
used in computing fully diluted earnings per share to reflect maximum dilution. For a market price of \$12.50 on March 25, 1970 in this example, 18,462 shares would be added for the first quarter computations and 4,615 shares would be added for the 1970 annual computations in computing fully diluted earnings per share.

Generally, options or warrants which expire or are cancelled will not affect earnings per share computations. The above examples are included only for those rare cases when they do. Most dilutive options and warrants will be exercised prior to expiration or cancellation.
30, 40 Anti-dilutive options and warrants do not enter earnings per share
computations,[29] since they would not be exercised when common stock could be purchased for less in the market than through exercise.

When dilutive options or warrants expire or are cancelled during a period, it may also be desirable to furnish supplementary earnings
22 per share data as described in Opinion paragraph 22, but previously
reported earnings per share data would not be retroactively adjusted for expirations or cancellations of warrants or options.

58. What Is a Period?

Q—What is a "period" as the term is used in the Opinion?

A—A "period" is the time for which net income is reported and earnings per share are computed.

However, when the treasury stock method or any method[30] requir-
Exh. B ing the computation of an average market price is used and the
reporting period is longer than three months, a separate computation is made for each three-month period.

If a period of less than a quarter is being reported upon, the average market price of common stock during the period encompassed by the income statement is used in applying the treasury stock methods. Other methods[30] requiring the use of average market prices also use the prices in effect during this shorter period.

[29]Except in the unusual situations described in Opinion paragraph 38 and in footnote 6 in Part I.

[30]For example, see Interpretations 67, 70, 77 and 79.

59. Share Averaging

Q—When the reporting period is longer than three months and the treasury stock method is applied, how is the weighted average of shares computed for the reporting period?

A—A weighted average of shares is computed based on the average market prices during each three months included in the Exh. B
reporting period. Thus, if the period being reported upon is six months, nine months, or one year, a weighted average[31] of shares is computed for each quarter. The weighted averages for all quarters are then added together, and the resulting total is divided by the number of quarters to determine the weighted average for the period.

Assume, for example, that a corporation had 25,000 shares of common stock outstanding during a year and also had granted options which resulted in the following incremental shares computed using the treasury stock method: 500 in the first quarter, none in the second quarter because they would have been anti-dilutive, 1,400 in the third quarter, and 1,000 in the fourth quarter. The weighted average of shares for the year could be computed either

$$25{,}500 + 25{,}000 + 26{,}400 + 26{,}000 = 102{,}900$$
$$102{,}900 \div 4 = \mathit{25{,}725}$$

or

$$\frac{500}{4} + \frac{1{,}400}{4} + \frac{1{,}000}{4} = 725$$
$$725 + 25{,}000 = \mathit{25{,}725}$$

60. Applying Ending and Average Market Prices

Q—How do the computations of primary and fully diluted earnings per share differ when the treasury stock method is applied for options and warrants and the ending market price of common stock is different from the average market price?

A—When the ending market price of common stock is higher 42
than the average market price for the period, the ending market price is used for the fully diluted computation to reflect maximum potential dilution. The use of different market prices for primary and fully diluted earnings per share computations naturally results in different numbers of shares for the two computations. The use of a higher

[31]See Interpretation 25 and Exhibit 3 for examples of computing a weighted average.

ending market price for fully diluted computations may also result in the assumption of exercise for fully diluted earnings per share but not for primary earnings per share. Year-to-date computations for fully diluted earnings per share may also be more complex when market prices of common stock increase and then decrease during the year, since the share computation is then made two ways and the greater number of shares is used in computing year-to-date fully diluted earnings per share. The above situations are illustrated in the following example.

Assume stock options are outstanding to obtain 5,000 shares of common stock at an exercise price of $10 per share. Assume also the following average and ending market prices of common stock during the calendar year:

	Average Market Price	*Ending Market Price*
First quarter	$11.11	$12.00
Second quarter	9.75	11.00
Third quarter	13.89	14.00
Fourth quarter	12.50	13.00

For primary earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the dilutive effect of the options:

	Primary Incremental Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	500(1)	500
Second quarter	—0—	250(2)
Third quarter	1,400(3)	633(4)
Fourth quarter	1,000(5)	725(6)

COMPUTATIONAL NOTES:

(1) $\dfrac{\$11.11 - \$10}{\$11.11} \times 5{,}000 = \mathit{500}$

(2) $500 + 0 = 500.$ $\quad 500 \div 2 = \mathit{250}$

(3) $\dfrac{\$13.89 - \$10}{\$13.89} \times 5{,}000 = \mathit{1{,}400}$

(4) $500 + 0 + 1{,}400 = 1{,}900.$ $\quad 1{,}900 \div 3 = \mathit{633}$

(5) $\dfrac{\$12.50 - \$10}{\$12.50} \times 5{,}000 = \mathit{1{,}000}$

(6) $500 + 0 + 1{,}400 + 1{,}000 = 2{,}900.$ $\quad 2{,}900 \div 4 = 725$

For fully diluted earnings per share, the treasury stock method would produce the following number of incremental shares to reflect the maximum dilutive effect of the options:

	Fully Diluted Incremental Shares	
	Quarterly EPS (1)	*Year-to-Date EPS*
First quarter	833	833
Second quarter	455(2)	644(3)
Third quarter	1,429	1,429(4)
Fourth quarter	1,154	1,154(5)

COMPUTATIONAL NOTES:

(1) Based on ending market price for each quarter.

(2) Note that the *average* market price for this quarter was anti-dilutive, so the computation is made only for fully diluted earnings per share.

(3) 833 + 455 = 1,288. 1,288 ÷ 2 = *644*
Use 644 weighted average since 644 is greater than 455 incremental shares based on ending market price.

(4) 833 + 455 + 1,429 = 2,717. 2,717 ÷ 3 = 906.
Use 1,429 incremental shares based on the ending market price since 1,429 is greater than 906.

(5) 833 + 455 + 1,429 + 1,154 = 3,871. 3,871 ÷ 4 = 968.
Use 1,154 incremental shares based on the ending market price since 1,154 is greater than 968.

Note that the two computations made for year-to-date fully diluted incremental shares may in some cases cause different market prices to be applied for the quarterly and year-to-date fully diluted computations. For example, assume that in the above illustration the average market price in the fourth quarter was $13 and the ending market price was $12.50. The $13 average market price would produce 1,154 incremental shares in the fourth quarter for both primary and fully diluted computations. In the annual fully diluted computation, however, the $12.50 ending market price would produce 1,000 incremental shares while the average number of shares for the four quarters would be only 968 (see computational note 5 above under fully diluted). Therefore the average market price would be used for the fourth quarter fully diluted computation and the ending market price would be used for the annual fully diluted computation.

A more comprehensive example of these points appears in Exhibit 4.

61. Treasury Stock Method at Exercise

Q—How is the treasury stock method applied for options and warrants which are exercised?

47 A—Common stock issued upon the exercise of options or war-
rants is included in the weighted average of outstanding shares from
42 the exercise date. The treasury stock method is applied for exercised
options or warrants from the beginning of the period to the exercise
date. For primary earnings per share, the computation for the period
prior to exercise is based on the average market price of common
stock during the period the exercised options or warrants were out-
47 standing (if the result is dilutive). Incremental shares are weighted
for the period the options or warrants were outstanding and shares issued are weighted for the period the shares were outstanding. For fully diluted earnings per share, however, the computation for the period prior to exercise is based on the market price of common stock when the options or warrants were exercised regardless of whether the result is dilutive or anti-dilutive. Incremental shares are weighted for the period the options or warrants were outstanding and shares issued are weighted for the period the shares are outstanding. These situations are illustrated in the following example.

Assume stock options are outstanding to obtain 5,000 shares of common stock at an exercise price of $10 per share. Assume also the following average and ending market prices of common stock during the calendar year:

	Average Market Price	*Ending Market Price*
First quarter	$11.11	$12.00
Second quarter	9.75	11.00
Third quarter	13.89	14.00
Fourth quarter	12.50	13.00

Also assume that 1,000 options were exercised May 1 when the market price of common stock was $10.50 per share and another 1,000 options were exercised September 1 when the market price of common stock was $15 per share. The average market price from April 1 to May 1 was $11.25 and from July 1 to September 1 was $13.

For primary earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the dilutive effect of the options:

	Primary Incremental Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	500	500
Second quarter	37(1)	269(2)
Third quarter	994(3)	510(4)
Fourth quarter	600	533(5)

COMPUTATIONAL NOTES:

(1) 1/3 of 111 incremental shares for 1,000 options exercised May 1 (using \$11.25 average market price for the period the options were outstanding). Remaining options are anti-dilutive.

(2) 500 + 37 = 537. 537 ÷ 2 = *269*

(3) 840 incremental shares for 3,000 options outstanding all of the quarter (exercise assumed at \$13.89 average market price for the quarter) plus 2/3 of the 231 incremental shares for 1,000 options outstanding for two months of the quarter (exercise assumed at \$13 average market price for the period the options were outstanding). 840 + 154 = *994*

(4) 500 + 37 + 994 = 1,531. 1,531 ÷ 3 = *510*

(5) 500 + 37 + 994 + 600 = 2,131. 2,131 ÷ 4 = *533*

In addition, outstanding shares would increase as follows to reflect options *exercised* May 1 and September 1:

	Increase in Outstanding Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	—0—	—0—
Second quarter	667(1)	333(2)
Third quarter	1,333(3)	667(4)
Fourth quarter	2,000(5)	1,000(6)

COMPUTATIONAL NOTES:

(1) 2/3 of 1,000 shares issued May 1 and outstanding for two months.

(2) 0 + 667 = 667. 667 ÷ 2 = *333*

(3) 1,000 shares issued May 1 plus 1/3 of 1,000 shares issued September 1.

(4) 667 + 1,333 = 2,000. 2,000 ÷ 3 = *667*

(5) 1,000 shares issued May 1 plus 1,000 shares issued September 1.

(6) 0 + 667 + 1,333 + 2,000 = 4,000. 4,000 ÷ 4 = *1,000*

For fully diluted earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the maximum dilutive effect of the options:

	Fully Diluted Incremental Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	833	833
Second quarter	380(1)	548(2)
Third quarter	1,079(3)	1,174(4)
Fourth quarter	692(5)	930(6)

COMPUTATIONAL NOTES:

(1) 364 incremental shares for 4,000 options outstanding all of the quarter (using $11 ending market price) plus 1/3 of 48 incremental shares for 1,000 options exercised May 1 (using $10.50 market price at exercise date).

(2) (667 + 48) + 380 = 1,095. 1,095 ÷ 2 = *548*. For the first quarter, 667 incremental shares for 4,000 options (using $12 ending market price) plus 48 incremental shares for 1,000 options exercised May 1 (using $10.50 market price at exercise date). See note 1 for second quarter. The incremental shares for the two quarters are then weighted.

(3) 857 incremental shares for 3,000 options outstanding all of the quarter plus 2/3 (333) = 222 incremental shares for 1,000 options exercised September 1 and outstanding two months.

(4) 857 incremental shares for 3,000 options outstanding for all of the three quarters based on $14 higher ending market price applied for all of the three quarters plus 4/9 (48) = 21 for the May 1 exercise plus 8/9 (333) = 296 for the September 1 exercise.

(5) Based on $13 market price and 3,000 options.

(6) 500 + 273 + 857 + 692 = 2,322. 2,322 ÷ 4 = *581* incremental shares for 3,000 options outstanding for four quarters using market prices of $12, $11, $14 and $13 for the respective quarters for computing the weighted average of incremental shares. Since 692 incremental shares determined by applying the ending market price is greater than 581 weighted incremental shares, 692 is used. The 692 is increased by 4/12 (48) = 16 shares for the May 1 exercise plus 8/12 (333) = 222 for the September 1 exercise. 692 + 16 + 222 = *930.*

In addition, outstanding shares would increase by the same number of shares as illustrated for the primary earnings per share computation for the options *exercised* on May 1 and September 1, i.e., 667 shares in the second quarter, 1,333 in the third quarter, 2,000 in the fourth quarter, 333 for the first six months, 667 for the first nine months, and 1,000 for the year.

62. Anti-Dilutive Exercise

Q—Is the treasury stock method applied for options and warrants which are exercised when the market price is below the exercise price?

A—Options or warrants usually would not be exercised in such a situation. The common stock obtainable upon exercise could be purchased in the market for less than the exercise price. However, in those rare cases where such an exercise does occur, the treasury 42
stock method is applied from the beginning of the year to the exercise date for fully diluted computations using the market price at the exercise date. The result will be anti-dilutive.

For primary computations, the average market price from the 36
beginning of the quarter to the exercise date is used, but only if the result is dilutive. Thus, when the average market price is less than the exercise price while the exercised options or warrants were outstanding, the exercised options or warrants are omitted from primary 30
computations.

Common stock issued upon exercise is included in the weighted 47
average of outstanding shares from the exercise date for both primary and fully diluted computations. Shares produced by the treasury stock method are included in the weighted average of outstanding shares for the time the exercised options or warrants were outstanding.

For example, assume stock options are outstanding to obtain 5,000 shares of common stock at an exercise price of $10 per share. Assume also the following average and ending market prices of common stock during the calendar year.

	Average Market Price	*Ending Market Price*
First quarter	$11.11	$12.00
Second quarter	9.75	11.00
Third quarter	13.89	14.00
Fourth quarter	12.50	13.00

On June 1, 1,000 options were exercised when the market price of common stock was $9.50 per share. The average market price from April 1 to June 1 was $9.65 per share.

For primary earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the dilutive effect of the options:

	Primary Incremental Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	500	500
Second quarter	—0—(1)	250
Third quarter	1,120(2)	540(3)
Fourth quarter	800	605(4)

COMPUTATIONAL NOTES:

(1) Average market prices for both outstanding options and exercised options are anti-dilutive.

(2) 1,120 incremental shares for 4,000 options outstanding all of the quarter.

(3) $500 + 0 + 1{,}120 = 1{,}620$. $1{,}620 \div 3 = \mathit{540}$

(4) $500 + 0 + 1{,}120 + 800 = 2{,}420$. $2{,}420 \div 4 = \mathit{605}$

In addition, outstanding shares would increase as follows to reflect options *exercised* June 1:

	Increase in Outstanding Shares	
	Quarterly EPS	Year-to-Date EPS
First quarter	—0—	—0—
Second quarter	333(1)	167(2)
Third quarter	1,000(3)	444(4)
Fourth quarter	1,000(5)	583(6)

COMPUTATIONAL NOTES:

(1) 1/3 of 1,000 shares issued June 1 and outstanding for one month.

(2) $0 + 333 = 333$. $333 \div 2 = \mathit{167}$

(3) 1,000 shares issued June 1.

(4) $0 + 333 + 1{,}000 = 1{,}333$. $1{,}333 \div 3 = \mathit{444}$

(5) 1,000 shares issued June 1.

(6) $0 + 333 + 1{,}000 + 1{,}000 = 2{,}333$. $2{,}333 \div 4 = \mathit{583}$

For fully diluted earnings per share, the treasury stock method would produce the following number of *incremental* shares to reflect the maximum dilutive effect of the options:

	Fully Diluted Incremental Shares	
	Quarterly EPS	*Year-to-Date EPS*
First quarter	833	833
Second quarter	329(1)	472(2)
Third quarter	1,143(3)	1,114(4)
Fourth quarter	923(5)	901(6)

COMPUTATIONAL NOTES:

(1) 364 incremental shares for 4,000 options outstanding all of the quarter *less* 2/3 (1,000 — 1,053) = — 35 to reflect the anti-dilutive effect of the exercise of 1,000 options outstanding 2 months during the quarter. 364 — 35 = *329*

(2) (667 — 53) + (364 — 35) = 943. 943 ÷ 2 = *472*. See note 1. For the first quarter, 667 incremental shares for 4,000 options are reduced by 53 anti-dilutive shares for 1,000 options exercised June 1. The net incremental shares for the two quarters are then weighted.

(3) 1,143 incremental shares for 4,000 options outstanding all of the quarter.

(4) 1,143 incremental shares for 4,000 options outstanding for all of the three quarters based on $14 higher ending market price applied for all of the three quarters *less* 5/9 (53) = — 29 for the June 1 anti-dilutive exercise.

(5) Based on $13 market price and 4,000 options.

(6) 667+ 364 + 1,143 + 923 = 3,097. 3,097 ÷ 4 = 774 incremental shares for 4,000 options outstanding for four quarters using market prices of $12, $11, $14 and $13 for the respective quarters for computing the weighted average of incremental shares. Since 923 incremental shares determined by applying the ending market price is greater than 774 weighted incremental shares, 923 is used. The 923 is decreased by 5/12 (— 53) = — 22 for the June 1 anti-dilutive exercise. 923 — 22 = *901*.

In addition, outstanding shares would increase by the same number of shares as illustrated for the primary earnings per share computation for the options *exercised* on June 1, i.e., 333 shares in the second quarter, 1,000 shares in the third and fourth quarters, 167 shares for the first six months, 444 shares for the first nine months, and 583 shares for the year.

63. "Substantially All" of Three Months

Q—How long is "substantially all" of a three-month period and why should exercise of options and warrants not be assumed in applying the treasury stock method "until" the market price has exceeded the exercise price for such a period?

A—"Substantially all" is not defined in the Opinion. Following
36 the recommendation[32] to not assume exercise before the three-month test is met (1) eliminates the need to make the computation until the market price has exceeded the exercise price for a significant period and (2) reduces "flip-flop" of options and warrants in and out of the computation because of the common stock's market price fluctuations above and below the exercise price.

Presumably, eleven weeks would be substantially all of a thirteen-week quarter. Therefore, the computation would be made for any quarter after the market price has once been above the exercise price for any eleven weeks during a quarter.

Note that this is a one-time test. Exercise need not be assumed for the computations *until* the test has been met, not *unless* the test is met in a particular quarter. Thus, once the test is met, the average market price would be computed thereafter unless the market prices are clearly anti-dilutive.

42 The test applies for both primary and fully diluted computations. But after the test has once been met, an ending market price which is above the exercise price is used for the fully diluted computation even though the average market price is below the exercise price.

36 This recommendation also applies to earnings per share computations for income statements prepared for periods which are less than a quarter. When applied to shorter periods, however, virtually all market prices in the shorter period should be above the exercise price or exercise need not be assumed. For a one-month statement, for

[32]The Board recommended that exercise of options and warrants not be assumed for earnings per share data *until* the market price has been above the exercise price for *substantially all* of the three months ending with the month for which the computation is being made.

example, the market prices during that month and for most of the two preceding months should be above the exercise price.

64. Total of Quarters May Not Equal Annual EPS

Q—Are previously reported earnings per share data ever retroactively adjusted or restated for changes in the incremental number of shares computed using the treasury stock method?

A—No, retroactive adjustment or restatement of previously re- 36, 41
ported earnings per share data are not made when the incremental number of shares determined by applying the treasury stock method changes. The Board realized that the total of four quarter's earnings per share might not equal the earnings per share for the year when market prices change and the treasury stock method is applied.

Computations for each quarter or other period are independent. Earnings per share data would not either be restated retroactively nor adjusted currently to obtain quarterly (or other period) amounts to equal the amount computed for the year or year to date.

65. Unusual Warrants and Their Equivalents

Q—To what kinds of securities does Opinion paragraph 37 apply?

A—Opinion paragraph 37 must be applied for earnings per share 37
computations for the following kinds of securities, all of which are classified as common stock equivalents:

1. Warrants which *require* the tendering of debt or other securities of the issuer or its parent or its subsidiary in full or partial payment of the exercise price.

2. Warrants which *permit* as an alternative the tendering of debt or other securities of the issuer or its parent or its subsidiary in full or partial payment of the exercise price.

3. Warrants whose proceeds from exercise must be applied toward the retirement of debt or other securities of the issuer. Such debt or other securities would have been issued with the warrants and the requirement to apply any proceeds toward retirement would usually be written into an indenture, making the requirement a contractual obligation.

4. Convertible securities which *require* the payment of cash upon conversion (regardless of their yield at time of issuance).

5. Convertible securities which *permit* the payment of cash as an alternative upon conversion, for example to obtain a greater number of common shares than could be obtained from straight conversion (regardless of their yield at time of issuance).

66. Securities Subject to Paragraph 37 Tests

Q—Are all of the securities listed in the preceding Interpretation subject to the two tests described in Opinion paragraph 37?

37 **A**—The two tests described in Opinion paragraph 37 are tests to determine whether certain warrants are dilutive or anti-dilutive. The "a" test is the usual test to determine if a warrant is dilutive. The "b" test is applied when securities can be tendered in lieu of cash to exercise a warrant. The computations to be made when either or both tests are met are described in Interpretations 67-70.

The "a" test (the market price of the related common stock must exceed the exercise price of the warrant or the convertible security considered the equivalent of a warrant) applies to warrants (1) which require the tendering of debt, (2) which permit the tendering of debt, and (3) whose proceeds must be used to retire debt.

The "b" test (the security to be tendered is selling at enough discount to establish an effective exercise price below the market price of the common stock obtainable) applies only to the debt or other securities which must or may be tendered toward the exercise price of the warrant (the debt listed in 1 and 2 in Interpretation 65). The "b" test gives recognition to the possibility that a warrant holder could purchase debt in the market at a discount and exercise a warrant by tendering the debt at its face amount, thereby effecting the purchase of the common stock for less than its market price.

These tests are demonstrated in the following example. Assume that a warrant may be exercised to purchase two shares of common stock by tendering either \$100 cash or a \$100 face value debenture when market prices are \$48 per common share, \$94 per debenture, and \$6 per warrant. The "a" test is not met ($2 \times \$48 = \$96$ market price of common does not exceed the exercise price of \$100 cash). The "b" test is met. (The \$94 market price of the debenture is below the \$96 market price for two shares of common. This may also be computed $\dfrac{\$94 \text{ market price of debenture}}{\$100 \text{ tender value of debenture}} \times \$50$ exercise price per share $= \$47$ effective exercise price per share.) Note that the market price of the warrant is not considered in either test.

The "a" and 'b" tests apply to securities on an individual basis. However, when Opinion paragraph 38 applies (see Interpretations 72-74), the securities subject to these tests are included in the aggregate computation required by that paragraph whether their individual effect is dilutive or anti-dilutive. 35, 38

67. Market Prices Used in Paragraph 37 Tests

Q—What market prices are used for the two tests described in Opinion paragraph 37?

A—The market prices used for these two tests and for the computations when the tests are met correspond to the market prices used for the treasury stock method (see Interpretations 52-56). Therefore, the computations are made for each quarter and the shares for the quarters are averaged for annual primary computations. 37

The market price of common stock for both tests is the average market price during each three-month quarter included in the period being reported upon. The ending market price of common stock is used, however, for fully diluted earnings per share if the ending price is *higher* than the average price. Exh. B 42

For the "b" test, the average market price of the debt or other security during each three-month quarter included in the period being reported upon is used. The ending market price of the debt or other security is used, however, for fully diluted earnings per share if the ending price is *lower* than the average price. 37

Usually, only one test will be met. In some cases, however, both tests will be met. Also, different tests may be met for primary and fully diluted computations. The computations to be made in these situations are explained in Interpretations 68 and 69. When neither test is met, these securities are not included in earnings per share computations unless Opinion paragraph 38 applies. 35, 38

68. Computations for Warrants Requiring the Tendering of Debt

Q—What computations are made under the "a" and "b" tests specified in Opinion paragraph 37 for warrants which require that debt or other securities be tendered upon exercise?

A—If either the "a" or "b" test described in Interpretations 66 and 67 is met when debt or other securities *must* be tendered toward the exercise price, exercise of the warrants is assumed. The debt or 37 other security is tendered at the amount it must be tendered (usually face amount). Interest, net of tax, on the debt is added back to net income in determining earnings applicable to common stock. Common stock is assumed to be issued on the exercise date. The treasury stock method is applied for any cash proceeds when cash is also to be tendered with the debt. The fact that both tests may sometimes be met does not affect the computations.

69. Computations for Warrants Allowing the Tendering of Debt

Q—What computations are made under the "a" and "b" tests specified in Opinion paragraph 37 for warrants which permit the tendering of debt or other securities upon exercise?

37 A—The computations depend upon the test met. If both tests are met, the computations depend upon the alternatives available since some warrants and their equivalents provide two or more exercise or conversion alternatives to the holder. For example, a warrant may be exercisable by paying $60 cash to obtain one share of common stock or by tendering $100 face value debt to obtain two shares of common stock. In such a case, debt *may* be tendered but is not required to be tendered.

When only the "a" test is met (because the debt or other security is selling for more than the amount for which it may be tendered), the treasury stock method is applied since the debt or other security would not be tendered toward exercise of the warrant or its equivalent.

When only the "b" test is met (the debt or other security which may be tendered is selling at enough discount to create an effective exercise price below the market price of the common stock), the procedures described in Interpretation 68 (for when debt or other securities *must* be tendered) are applied.

If *both* the "a" and "b" tests described above are met when debt or other securities *may* be tendered toward the exercise price or if two or more exercise or conversion alternatives meet one test (whether or not both tests are met), the computation should be based upon the
58 alternative which meets the test and is more (or most) advantageous to the holder of the warrant or its equivalent.

Exh. B The "a" and "b" tests are applied for each quarter using the market prices specified in Interpretation 67. When either test is met, the computations are made for that quarter. Different tests may apply for different quarters in the period. The shares determined for each quarter are averaged for year-to-date primary computations. In fully diluted year-to-date computations, the greater of the average number of shares included in the fully diluted quarterly computations or the number of shares determined by applying ending market prices is used.

70. Computations for Warrants Whose Proceeds Are Applied To Retire Debt

Q—How are warrants whose proceeds must be used to retire debt or other securities included in earnings per share computations?

A—When debt or other securities of the issuer require that the 37
proceeds from the exercise of warrants or their equivalents be applied toward retirement of those securities, exercise of the warrants is assumed at the beginning of the period (or time of issuance, if later). The proceeds from exercise are assumed to have been used to purchase the securities to be retired at the date of assumed exercise.

These computations are made on a quarterly basis. The shares Exh. B
determined for each quarter are averaged for annual earnings per share computations. The purchase price to be used is the average market price during each three-month quarter for the securities assumed to have been purchased. To reflect maximum potential
dilution, the purchase price for the computation of fully diluted 42
earnings per share is the market price of the securities to be retired at the end of the period if this price is *higher* than the average market price.

Exercise of the warrants is not assumed for either primary or fully 30, 40
diluted earnings per share unless the market price of the related common stock exceeds the exercise price of the warrants.[33] When
exercise is assumed and the proceeds from exercise are used to pur- 37
chase securities to be retired, interest (net of tax) on any debt retired must be added back to net income in determining earnings applicable to common stock. Any excess amount from the assumed exercise of the warrants above the amount needed for the purchase of securities is used to purchase common stock under the treasury stock method.

[33]Exercise may be assumed, however, if Opinion paragraph 38 applies. See Interpretations 72-74.

71. Treasury Stock Method for Convertibles

Q—How are convertible securities which require or permit the payment of cash at conversion included in earnings per share computations?

A—Convertible securities which require or permit the payment
37 of cash at conversion are considered the equivalents of warrants and
are therefore always[34] common stock equivalents.

Convertible securities requiring the payment of cash are assumed
to be converted at the beginning of the period (or time of issuance,
if later) and the if converted method is applied. Proceeds from con-
version are used to purchase common stock under the treasury stock
method. Thus, the incremental number of shares assumed to be
outstanding is the difference between the number of shares issued
upon assumed conversion and the number of shares assumed pur-
chased under the treasury stock method. If the net result of the
aggregate computation of applying both the if converted method and
the treasury stock method is dilutive, these computations are included
in both primary and fully diluted earnings per share. The computa-
30, 40 tions are not included, however, if the net result is anti-dilutive.[35]

37 Some convertible securities permit the payment of cash at conver-
sion to obtain a more favorable conversion rate. The procedures
described in the preceding paragraph are applied for such securities
58 except that no proceeds are assumed to be received upon conversion
whenever the amount of cash to be paid exceeds the market value
of the additional shares obtainable. The treasury stock method
therefore cannot be applied when this condition exists and only the
37 if converted method is applied (if the result is dilutive).[35]

When several conversion alternatives exist (for example, permit-
ting the payment of different amounts of cash for different conversion
rates), the computation should give effect to the alternative which is
58 most advantageous to the holder of the convertible security.

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[34]Unless issued before June 1, 1969 and classified under election "b" of Opinion paragraph 46.

[35]Conversion may be assumed even if the result is anti-dilutive when Opinion paragraph 38 applies. See Interpretations 72-74 and Opinion paragraphs 35 and 38.

72. Anti-Dilutive Options and Warrants Included

Q—When paragraph 38 of the Opinion applies (the number of common shares obtainable upon exercise of all options and warrants exceeds 20% of the number of common shares outstanding at the end of the period), are anti-dilutive options and warrants assumed to be exercised as well as dilutive options and warrants?

A—Yes, when Opinion paragraph 38 applies, all options and 38
warrants and their equivalents are assumed to be exercised (or 35
converted) whether they are dilutive or anti-dilutive. Under this
exception to the general rule that computations should not give effect 38
to anti-dilution, all of the computations specified in paragraphs 36, 36
37, and 38 are made and aggregated. If the net result is dilutive, all 37, 38
are included. If the net result is anti-dilutive, all are excluded.

73. No Order for Exercise

Q—When Opinion paragraph 38 applies and several issues of options and warrants with different exercise prices are outstanding, which options and warrants should be assumed to be exercised to obtain common stock under the treasury stock method, i.e., may anti-dilutive options and warrants be used in applying the treasury stock method or is the treasury stock method applicable only for dilutive options and warrants?

A—All options and warrants are assumed to be exercised when
Opinion paragraph 38 applies without regard to whether the proceeds 38
will be applied to purchase common stock under the treasury stock method or will be applied to the retirement of debt. Specific options or warrants are not to be allocated for the treasury stock method, but rather all options and warrants are assumed to be exercised and the number of common shares assumed to be repurchased under the treasury stock method may not exceed 20% of the number of common shares outstanding at the end of the period.

74. Explanation of 20% Provision

Q—How is the 20% provision described in Opinion paragraph 38 applied?

A—20% is used in two ways in Opinion paragraph 38. First, a 38
20% *test* is applied[36] to outstanding common shares. If the 20%

[36]A corporation which has made election "b" of Opinion paragraph 46 would apply this test for both primary and fully diluted earnings per share computations, since the number of shares obtainable from options and warrants may differ for the two computations as described in Interpretation 81.

test is met, an aggregate computation is required and all options and warrants and their equivalents are assumed to be exercised. Then a 20% *limitation* is applied to the number of common shares purchased under the treasury stock method.

Even though the 20% test is met, the number of shares purchased under the treasury stock method may be below the 20% limitation if the market price is high relative to the exercise price. For example, if 1,000,000 common shares and warrants to obtain 500,000 shares were outstanding, the 20% test would be met and the 20% limitation for the treasury stock method would be 200,000 shares. At an exercise price of $10 and a market price of $50, however, only 100,000 shares could be purchased under the treasury stock method.

Note that the 20% limitation applies only to shares assumed *purchased* under the treasury stock method. It does not apply to the number of incremental shares which results from the computation. In the above example, 400,000 incremental shares resulted from the assumed issuance of 500,000 shares upon exercise and the assumed purchase of 100,000 shares under the treasury stock method.

35, 37 In addition, some warrants and their equivalents for which the
treasury stock method may not be applicable result in the assumed
issuance of common stock. They are therefore included in applying
38 the 20% test and are included in the aggregate computation if the
37 test is met. For example, warrants whose proceeds must be used to
38 retire debt are included in applying the 20% test and in the aggregate
37 computation if the test is met. Only the proceeds in excess of the
amount required for debt retirement would be eligible for the treasury
stock method, however. Warrants assumed to be exercised by tender-
ing debt or other securities would also be included in applying the
38 20% test and in the aggregate computation if the test is met. But
37 only if both cash and debt or other securities were assumed tendered
would there be any proceeds eligible for the treasury stock method.
Convertible securities which require or permit the payment of cash
at conversion are considered the equivalent of warrants. Such con-
vertible securities would be included in applying the 20% test and
38 in the aggregate computation if the test is met.

33 Most convertible securities, however, (those which do *not* require or permit the payment of cash at conversion) are *not* included in applying the 20% test. Nor are other securities which are not options or warrants or their equivalents included in the 20% test. For

example, the usual participating securities, two-class common stocks 27
and common stock issuable when specified conditions are met are
not included in the 20% test.

Securities which are not included in the 20% test are not included 38
in the aggregate computation[37] described in Opinion paragraph 38.
Thus, even if the net result of the aggregate computation is anti-
dilutive and therefore not included in the earnings per share compu-
tation, other securities not included in the aggregate computation
would be included in the earnings per share computations if they 15
are dilutive.

75. Original Issue Premium or Discount

Q—What treatment is accorded to any original issue premium or discount when debt is assumed acquired under the provisions of Opinion paragraphs 37 and 38?

A—Original issue premium or discount is treated as specified in
Interpretation 40, i.e., applicable premium or discount amortized
during the period is eliminated from net income. Unamortized pre- 51
mium or discount is not included in earnings applicable to common
stock and does not affect earnings per share.

76. Redemption Premium or Discount

Q—What treatment is accorded to any redemption premium or discount when debt is assumed acquired under the provisions of Opinion paragraphs 37 and 38?

A—Redemption premium or discount, i.e., the difference between
the purchase price and the "book" carrying amount of debt, is ignored 51
for earnings per share computations.

Redemption premium or discount could occur only when the proceeds from the assumed exercise of options and warrants are applied to purchase debt at the market price under the provisions of either Opinion paragraph 37 or paragraph 38. Redemption premium or discount is not included in earnings applicable to common stock and does not affect earnings per share.

[37]However, convertible debt assumed to be retired with proceeds from exercise in excess of the amount required for applying the treasury stock method would be included in the aggregate computation and its interest would be eliminated as described in Opinion paragraph 51.

36, 42 Common shares are, of course, assumed to be issued for all options and warrants assumed to be exercised.

77. Debt Purchased Under Paragraph 38

Q—What debt may the issuer assume is purchased when the provisions of Opinion paragraph 38 apply?

A—The issuer may select any debt which is eligible to be retired
38 for assumed purchase when the provisions of Opinion paragraph 38 apply. This includes convertible debt (both common stock equivalents and other potentially dilutive securities) except that convertible
30, 40 debt may not be assumed purchased if the purchase would be antidilutive (that is, result in less dilution). Debt is eligible to be retired when it either may be "called" or is trading and could be purchased in the market.

38 The same debt is assumed purchased for both primary and fully diluted earnings per share computations. Different amounts of debt may be assumed purchased, however, since different market prices may have to be used for the primary and fully diluted computations for the treasury stock method. The average market price of the debt during each quarter for which the computations are made is used for both the primary and fully diluted computations under Opinion paragraph 38.

78. Compensating Balances Excluded

Q—When Opinion paragraph 38 applies and a loan is assumed to be paid, what treatment is accorded to any compensating balance maintained for the loan?

A—A compensating balance maintained for a loan assumed to be paid is excluded from consideration in applying Opinion paragraph
38 38. Although a compensating balance increases the effective interest rate on a loan to the borrower, only the actual interest paid or accrued (less applicable income tax) is adjusted against net income for earnings per share computations.

79. Investments Under Paragraph 38

Q—What securities are eligible for assumed purchase as investments when the provisions of Opinion paragraph 38 apply?

38 A—Only U.S. government securities and commercial paper are eligible for assumed purchase as investments when the provisions of Opinion paragraph 38 apply. Tax-exempt securities of state and

local governments are not eligible. The same securities are assumed purchased as investments for both primary and fully diluted earnings per share computations. Different amounts may have to be assumed invested for primary and fully diluted computations, however.

U.S. government securities, in the context of Opinion paragraph 38, are securities issued by the federal government, not merely securities guaranteed by the federal government. Typically the securities to be considered would be short-term securities, such as Treasury bills.

80. Debt Eligible Only While Outstanding

Q—When Opinion paragraph 38 applies and debt assumed purchased was actually outstanding only part of the period, may the assumed purchase apply for the entire period?

A—No, debt issued or retired during the period may be assumed
purchased at its average market price under Opinion paragraph 38 38
only for the time the debt was actually outstanding. Since all computations under this paragraph are made on a quarterly basis, the issue or retirement typically affects only one quarter. An investment in U.S. government securities or commercial paper must be assumed for the time when debt was not outstanding and therefore could not be purchased. Any difference in interest (net of tax) between the debt and the investment naturally is reflected in earnings applicable to common stock.

81. Computations May Differ for Primary and Fully Diluted when Paragraph 38 Applies

Q—Will Opinion paragraph 38 always apply for both primary and fully diluted computations if it applies to either?

A—No, in some cases Opinion paragraph 38 may apply for fully 38
diluted computations but not for primary computations. This could
occur when an issuer has made election "b" under Opinion paragraph 46
46 and the common shares obtainable upon exercise of options and warrants issued before June 1, 1969 exceed 20% of the common shares outstanding. Opinion paragraph 38 applies in such a case for fully diluted but not for primary computations because the options and warrants issued before June 1, 1969 are included only in fully diluted computations.

Even if the common shares obtainable upon exercise of options and warrants issued before June 1, 1969 do not exceed 20% of the

outstanding common shares when election "b" is in effect, the subse-
quent issuance of additional options or warrants could cause Opinion
38 paragraph 38 to apply for fully diluted but not for primary computa-
tions. In such a case, Opinion paragraph 38 would be applied only
for fully diluted computations because options and warrants issued
46 before June 1, 1969 would not be included in primary computations.

The computation of primary and fully diluted earnings per share
38 would also differ if Opinion paragraph 38 applied for both computa-
30 tions, but the net result in primary is anti-dilutive and is dilutive in
42 fully diluted. This could occur when the ending market price is above
36 the exercise price but the average market price is below the exercise
38, 42 price. In such a case, the computations would be included only for
determining fully diluted earnings per share.

82. Deferred Compensation Stock Option

Q—What treatment for earnings per share computations should be accorded to an employee deferred compensation plan with the compensation to be paid in stock?

A—Stock to be issued to an employee under a deferred compen-
35 sation plan is considered a stock option. The time of issuance is the
29 agreement date (or "date of grant"). The fact that the employee may
57, 58 not receive (or be able to sell) the stock until more than five or ten
years from the statement date does not affect the computation. Ac-
cordingly, all shares to be issued are considered outstanding and the
36 treasury stock method is applied to determine the incremental number
of shares to be included in the earnings per share computations. The
exercise amount of the option is the sum of the amount the employee
must pay, the unamortized deferred compensation, and any tax
benefit[38] credited to capital surplus. The exercise amount is divided

[38]The tax benefit is the "windfall" tax credit resulting from an increase in the market price of the stock between the date the plan is entered into and the date the compensation charge is deductible for tax purposes (based on market value of the stock when measurable). Since the compensation is charged on the financial statements against the period benefited, the tax related to the charge results in a timing difference for interperiod tax allocation. If the market price of the stock increases, the additional reduction in taxes is a permanent difference (i.e., a "windfall" gain). Some persons believe this difference should be credited to income while others believe it should be credited to capital surplus. (See pages 11-12 of *Accounting for Income Taxes: An Interpretation of APB Opinion No. 11* by Donald J. Bevis and Raymond E. Perry, AICPA, 1969). If credited to capital surplus, the "windfall" gain is considered part of the proceeds from the stock compensation plan which would be used to purchase stock under the treasury stock method.

by the market price[39] per share of the common stock to determine the number of shares assumed to be purchased.

For primary earnings per share computations, the average unamortized deferred compensation for the period and the average market price of the issuer's common stock are used. For fully diluted earnings per share computations, the unamortized deferred compensation at the end of the period and, if higher than the average market price, the ending market price of the issuer's common stock are used.

For example, assume that on December 31, 1968[40] a corporation grants options to its president for the purchase of 6,000 shares of its common stock at \$2 per share, with options for 1,000 shares exercisable each July 1 and January 1 for three years as partial compensation for services during the preceding six months. The shares issued cannot be sold within three years of the issue date. At time of the grant of the options (December 31, 1968[41]), the 6,000 shares have a fair value of \$10 per share (the market price of common is \$12 per share). Also assume that the fair value per share increases steadily during the three years at the rate of \$1 per quarter (the market price of common increases \$1.20) and the tax rate is 50%. (The corporation follows the practice of crediting the "windfall" tax benefit to capital surplus.) The total compensation to be charged to expense over the three-year period is \$48,000 $\left(\frac{\$10}{\$12} \times \$12 = \$10\right.$ fair value reduced by the \$2 option price results in \$8 per share compensation multiplied by 6,000 shares$\left.\right)$.

At March 31, 1969, the unamortized deferred compensation is \$44,000 (\$48,000 − \$4,000) and the windfall tax benefit is \$3,600 (\$1.20 × 6,000 = \$7,200 increase in market multiplied by .50 tax

[39]Fair value per share rather than market price is used if a restriction on the sale of the stock makes it worth less than the market price of freely trading stock. Fair value might be stated as a fraction or a percentage of market price. For example, if the restriction reduced the value approximately 1/6, a stock with a \$12 market price would have a fair value of \$10 per share (5/6 of \$12).

[40]Plans entered into after April 21, 1969 are subject to the 1969 *Tax Reform Act*. Because the income tax treatment for such plans under this Act is different from that described in this Interpretation, many persons believe the use of such plans in the future will decrease substantially.

[41]This example assumes the corporation makes election "a" under Opinion paragraph 46. If election "b" were made, only the fully diluted computations would apply, since "time of issuance" of the options is the date of grant.

rate). The total exercise price is \$12,000 (6,000 × \$2). For primary computations, averages of \$46,000 unamortized deferred compensation and \$1,800 windfall tax benefit plus the \$12,000 total exercise price produce \$59,800 "proceeds" for the total exercise amount. Dividing by the average fair value of \$10.50 (\$10 + \$11 = \$21 divided by 2) results in 5,695 shares assumed repurchased under the treasury stock method. Therefore, 305 incremental shares (6,000 − 5,695) are assumed to be outstanding for the first quarter in the primary computation. For fully diluted computations, 582 incremental shares are computed:

$$\$44{,}000 + \$3{,}600 + \$12{,}000 = \$59{,}600$$
$$\$59{,}600 \div \$11 = 5{,}418$$
$$6{,}000 - 5{,}418 = \mathit{582}$$

At June 30, 1969, the second quarter primary computation would include 835 incremental shares and fully diluted would include 1,067 incremental shares computed:

$$\$42{,}000 + \$5{,}400 + \$12{,}000 = \$59{,}400$$
$$\$59{,}400 \div \$11.50 = 5{,}165$$
$$6{,}000 - 5{,}165 = \mathit{835}$$

$$\$40{,}000 + \$7{,}200 + \$12{,}000 = \$59{,}200$$
$$\$59{,}200 \div \$12 = 4{,}933$$
$$6{,}000 - 4{,}933 = \mathit{1{,}067}$$

On July 1, 1969, 1,000 shares would be issued to the president and are outstanding shares thereafter.[42] At September 30, 1969, the treasury stock method would produce 560 incremental shares for the third quarter primary and 769 incremental shares for fully diluted computed:

$$\$38{,}000 + \$7{,}500 + \$10{,}000 = \$55{,}500$$
$$\$55{,}500 \div \$12.50 = 4{,}440$$
$$5{,}000 - 4{,}440 = \mathit{560}$$

$$\$36{,}000 + \$9{,}000 + \$10{,}000 = \$55{,}000$$
$$\$55{,}000 \div \$13 = 4{,}231$$
$$5{,}000 - 4{,}231 = \mathit{769}$$

[42] The amount of the tax benefit for each share issued will be the lesser of the difference between the \$2 exercise price and (1) the market price of the unrestricted stock when the restricted stock is issued or (2) the market price when restrictions lift. Changes in the windfall tax gain after the stock is issued are ignored in this computation since the compensation paid in stock is considered finalized upon issuance in this example.

At December 31, 1969, the treasury stock method would produce 963 incremental shares for the fourth quarter primary and 1,143 incremental shares for fully diluted computed:

$$\$34{,}000 + \$10{,}500 + \$10{,}000 = \$54{,}500$$
$$\$54{,}500 \div \$13.50 = 4{,}037$$
$$5{,}000 - 4{,}037 = \mathit{963}$$
$$\$32{,}000 + \$12{,}000 + \$10{,}000 = \$54{,}000$$
$$\$54{,}000 \div \$14 = 3{,}857$$
$$5{,}000 - 3{,}857 = \mathit{1{,}143}$$

The deferred compensation payable in stock would produce the following shares of common stock to be included in the corporation's 1969 annual earnings per share computations:

	Primary Computations	*Fully Diluted Computations*
Incremental shares from application of the treasury stock method:		
First quarter	305	1,067(1)
Second quarter	835	1,067
Third quarter	560	1,143(2)
Fourth quarter	963	1,143
Totals	2,663	4,420
Shares for weighted average (divide totals by 4)	666	1,105
Shares issued (1,000 ÷ 2)	500	500
Total shares	1,166	1,605

COMPUTATIONAL NOTES:

(1) 582 incremental shares computed for first quarter fully diluted not used in annual computation. 1,067 incremental shares based on $12 fair value at July 1 "exercise date" when the stock was issued.

(2) 769 incremental shares computed for third quarter fully diluted not used in annual computation. 1,143 incremental shares based on $14 ending fair value for the fourth quarter.

If the market or fair value of the stock should subsequently fall below the market value at the date of grant, the application of the treasury stock method would be anti-dilutive. In such a case, the treasury stock method would not be applied and any unissued shares 30, 40
would not be considered outstanding for earnings per share computations.

The procedures described above are also used for deferred compensation plans to be paid in stock which do not require the employee

35 to make a payment to obtain the stock. In such plans, the option
price is zero. The period for measuring compensation under such
plans is generally the period over which the restrictions lift. Although
36 the plans are different, the procedures described in this Interpretation
are applied with the zero option price offset by an increase in the
unamortized deferred compensation. Also, these procedures would
be applied for earnings per share computations whether or not the
39 plan has been recorded by the company prior to the issuance of the
stock.

Whether or not these procedures apply to "phantom" or "shadow" stock deferred compensation plans depends upon the nature of the plan. These plans may require the employer corporation to (1) either issue stock or pay cash for the stock's value to the employee at a future date or (2) pay the employee in cash at a future date for any increase in the stock's value. Most "phantom" stock plans are based on the employer corporation's stock but some of these plans are based on the stock of an unrelated corporation selected by the employee. Additionally, these plans may either be "funded" or "unfunded." Funding may be accomplished by periodically setting aside any cash to be paid out under the plan or by purchasing stock (which may subsequently be issued or sold to fulfill the plan) or, in the case of plans based on the employer corporation's stock, by reserving unissued or treasury shares.

Phantom stock deferred compensation plans based on the employer corporation's stock (or the stock of a parent or subsidiary corporation) are included in earnings per share computations under the procedures described above in this Interpretation. However, plans requiring the employer to pay cash rather than stock to the employee are an exception if stock will not be sold to provide the cash. Such plans affect earnings per share only through any compensation charged against net income, since the stock value determines the compensation amount and stock is not issued.

Phantom stock plans based on the stock of an unrelated corporation likewise affect earnings per share only through any compensation charged against net income, since the employer corporation's stock is in no way involved in the plan.

83. Stock Subscriptions Are Warrants

Q—How are stock subscriptions included in earnings per share computations?

A—Fully paid stock subscriptions are considered outstanding stock whether or not the shares have actually been issued. Partially
paid stock subscriptions are considered the equivalents of warrants 35
and are therefore always[43] common stock equivalents. The unpaid balance is assumed to be proceeds used to purchase stock under the treasury stock method.

The number of shares included in earnings per share computations for partially paid stock subscriptions is the difference between the number of shares subscribed and the number of shares assumed to be purchased under the treasury stock method.

The procedures described above are used for subscriptions to purchase convertible securities as well as for subscriptions to purchase common stock. Any incremental convertible securities resulting are then assumed to be converted into common stock if the result is dilutive (see Interpretation 84).

84. Options or Warrants to Purchase Convertible Securities

Q—What treatment is accorded options or warrants to purchase convertible securities?

A—Options or warrants to purchase convertible securities are 36
assumed to be exercised to purchase the *convertible* security whenever the market price of both the convertible security and the common stock obtainable upon conversion are above the exercise price of the
warrant. However, exercise is not assumed unless conversion of the 30, 40
outstanding convertible securities is also assumed. The treasury stock 36
method is applied to determine the incremental number of convertible securities which are assumed to be issued and immediately converted
into common stock. The if converted adjustments which would be 51
applicable to the incremental convertible securities are ignored since the adjustments would be self-cancelling, i.e., any interest or dividends imputed to the incremental convertible securities would be cancelled in applying the if converted method.

For example, assume that a corporation issued 10,000 warrants exercisable to obtain its $100 par value 5% convertible debt. Each warrant may be exercised at $90 to obtain one convertible bond. Each bond is convertible into two shares of common stock. The market

[43]Unless subscribed before June 1, 1969 and election "b" under Opinion paragraph 46 is made.

prices of the securities are \$46 per common share and \$95 per convertible bond. The warrants are dilutive ($2 \times \$46 = \$92$ which is greater than the \$90 exercise price).

36 Assumption of exercise would produce \$900,000 proceeds, which would be used to purchase 9,474 convertible bonds, resulting in 526 incremental bonds. Conversion would be assumed and 1,052 shares of common ($2 \times 526 = 1{,}052$) would be assumed issued to replace the 526 convertible bonds.

If the market price of common were \$45 per share or less, exercise would not be assumed (for example, at \$42 per share, $2 \times \$42 = \$84$ which is less than \$90).

33 The classification of the convertible security as a common stock equivalent or other potentially dilutive security determines whether the incremental number of common shares enters primary and fully diluted or enters only fully diluted earnings per share computations.

TWO-CLASS COMMON STOCK AND PARTICIPATING SECURITIES

85. EPS Treatment of Two-Class and Participating Securities

Q—How are two-class common stocks and participating securities treated for earnings per share computations?

A—Two-class common is a term applied when a corporation has issued more than one class of common stock (for example, Class A and Class B). A participating security is a security eligible to participate in dividends with common stock; often a fixed amount is guaranteed to the participating security, then common is paid a dividend at the same rate, and the security participates with common on a reduced ratio thereafter. Classes of common stock other than "ordinary" common stock and the participating securities may be convertible into "ordinary" common stock or may be nonconvertible and may or may not be senior to common stock.

For example, some stocks may be designated as common stock (e.g., Class B Common), but their terms and conditions are equivalent to preferred stock (by limiting their voting rights or the amount of dividends they may receive and by giving them preferences in liquidation). If dividends are guaranteed in some way but limited in participation to a maximum amount for a particular class of common stock, that common stock is considered the equivalent of a senior security to the extent it is to share in earnings.

If dividend participation for a particular class of common stock
is not limited but the participation is at a rate different from the
"ordinary" common stock (for example, participating equally to some
amount per share and partially participating thereafter), the two-class 54
method is used. The two-class method is also used for participating
preferred stock which is not limited as to participation in dividends
with common stock. The two-class method is modified, however, 55
when it is applied for a convertible security. (See Interpretation 87.)
To be applied for a convertible security, the two-class method must
result in greater dilution than would result from application of the if
converted method.

A determination of the status of a two-class common stock or 60
other participating security as a common stock equivalent or as an
other potentially dilutive security is based on an analysis of all the
characteristics of the security, including the ability to share in the
earnings potential of the issuing corporation on substantially the
same basis as the common stock. Dividend participation *per se* does
not make such a security a common stock equivalent.

The two-class method of computation for nonconvertible securities is discussed in Interpretation 86. The two-class method of computation for convertible securities is discussed in Interpretation 87.

86. Two-Class Method for Nonconvertible Securities

Q—How is the two-class method applied for nonconvertible securities?

A—The two-class method for nonconvertible securities is an 55
earnings allocation formula which determines earnings per share for
each class of common stock and participating security according to
dividends paid and participation rights in undistributed earnings.

Under the two-class method, net income is first reduced by the amount of dividends actually paid for the period to each class of stock and by the contractual amount of any dividends (or interest on participating income bonds) which must be paid (for example, unpaid cumulative dividends or dividends declared during the period and paid during the following period). The remaining unencumbered undistributed earnings is secondly allocated to common stock and participating securities to the extent each security may share in earnings. The total earnings allocated to each security is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

This amount is 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. For this computation, outstanding common stock (the "ordinary" class of common stock) includes the usual common stock equivalent securities assumed to be converted or exercised for primary computations and includes these securities and all other potentially dilutive securities assumed to be converted or exercised for fully diluted computations. Although reporting earnings per share for each class of security may be desirable, earnings per share must be reported for the "ordinary" class of common stock.

The application of the two-class method for a nonconvertible security is illustrated in the following example. Assume that a corporation had 5,000 shares of $100 par value nonconvertible preferred stock and 10,000 shares of $50 par value common stock outstanding during 1969 and had a net income of $65,000. The preferred stock is entitled to a noncumulative annual dividend of $5 per share before any dividend is paid on common. After common 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. That is, after preferred and common have been paid dividends of $5 and $2 per share respectively, preferred participates in any additional dividends at a rate of two-thirds of the additional amount paid to common on a per share basis. Also assume that for 1969 preferred shareholders have been paid $27,000 (or $5.40 per share) and common shareholders have been paid $26,000 (or $2.60 per share). Earnings per share for 1969 would be computed as follows under the two-class method for nonconvertible securities:

Net income		$65,000
Less dividends paid:		
Preferred	$27,000	
Common	26,000	53,000
Undistributed 1969 earnings		$12,000

Allocation of undistributed earnings:

To preferred:

$$\frac{.4(5{,}000)}{.4(5{,}000) + .6(10{,}000)} \times \$12{,}000 = \$3{,}000$$

$$\$3{,}000 \div 5{,}000 \text{ shares} = \$.60 \text{ per share.}$$

To common:

$$\frac{.6(10{,}000)}{.4(5{,}000) + .6(10{,}000)} \times \$12{,}000 = \$9{,}000$$

$$\$9{,}000 \div 10{,}000 \text{ shares} = \$.90 \text{ per share.}$$

Earnings per share amounts:

	Preferred Stock	*Common Stock*
Distributed earnings	\$5.40	\$2.60
Undistributed earnings	.60	.90
Totals	\$6.00	\$3.50

87. Two-Class Method for Convertible Securities

Q—How is the two-class method applied for convertible securities?

A—Most convertible two-class common stocks and other con- 51
vertible participating securities are assumed to be converted and the
if converted method is applied for earnings per share computations.
The two-class method is rarely appropriate for such convertible secur- 54
ities and may be applied only when it results in greater dilution than
would result from the if converted method.

When the two-class method is used for a convertible two-class 55
common or other convertible participating security, net income is first allocated under the procedure described in Interpretation 86 for dividends for the current period which were paid or declared or are cumulative if not paid or declared. Conversion of the convertible two-class common and participating securities is then assumed, but adjustments to net income usually made for the if converted method are *not* made. Unencumbered undistributed earnings is divided by the total of all common shares outstanding and assumed outstanding from conversions and exercise. The resulting amount per share is added to the amount of the dividends per share allocated to each class of security to determine the earnings per share for each class of security. Although reporting earnings per share for each class of security may be desirable, earnings per share must be reported for the "ordinary" class of common stock.

The application of the two-class method for a convertible security is illustrated in the following example. Assume that a corporation had 10,000 shares of Class A common stock (the "ordinary" common) and 5,000 shares of Class B common stock outstanding during 1969 and had a net income of $65,000. Each share of Class B is convertible into two shares of Class A. The Class B is entitled to a noncumulative annual dividend of $5 per share. After Class A has been paid a dividend of $2 per share, Class B then participates in any additional dividends on a 40:60 *per share* ratio with Class A. For 1969 the Class A shareholders have been paid $26,000 (or $2.60 per share) and the Class B shareholders have been paid $27,000 (or $5.40 per share). Earnings per share for 1969 would be computed as follows:

Under the if converted method:

$$\frac{\$65{,}000}{20{,}000 \text{ shares*}} = \$3.25 \text{ per share}$$

*Conversion of Class B is assumed.

Under the two-class method for convertible securities:

Net income		$65,000
Less dividends paid:		
Class A common	$26,000	
Class B common	27,000	53,000
Undistributed 1969 earnings		$12,000

Allocation of undistributed earnings:

$$\frac{\$12{,}000}{20{,}000 \text{ shares}} = \$.60 \text{ per Class A share.}$$

$$2(.60) = \$1.20 \text{ per Class B share.}$$

Earnings per share amounts:

	Class A	*Class B*
Distributed earnings	$2.60	$5.40
Undistributed earnings	.60	1.20
Totals	$3.20	$6.60

The two-class method may be used in this case since it results in greater dilution than the if converted method.

SECURITIES ISSUABLE UPON SATISFACTION OF SPECIFIED CONDITIONS

88. Contingent Shares

Q—How is common stock contingently issuable or subject to recall classified and treated in earnings per share computations?

A—Common stock contingently issuable or subject to contingent 27
recall is always[44] classified as a common stock equivalent unless it will be issued upon the mere passage of time and is therefore considered to be outstanding for both primary and fully diluted computations. Whether (1) the stock will be issued in the future upon the 61
satisfaction of specified conditions, (2) the stock has been placed in escrow and part must be returned if specified conditions are not met, or (3) the stock has been issued but the holder must return part if specified conditions are not met does not affect the classification of contingent shares.

When certain conditions are not met, however, contingent shares are omitted from primary or from primary and fully diluted earnings per share computations. Typical examples of the conditions to be met for contingent shares are (1) the passage of time along with other conditions, (2) the maintenance of some level of earnings, (3) the attainment of some level of earnings, and (4) changes in market prices which modify the number of shares to be issued.

Contingent shares are included in both primary and fully diluted 62
computations when the conditions for their issuance are currently being met. If additional shares would be contingently issuable if a higher earnings level were being attained currently, the additional shares are included only in fully diluted computations (giving effect to the higher earnings level) but only if dilution results. Contingent shares based on (1) the attainment of increased earnings levels above the present earnings level or (2) the maintenance of increased earnings above the present level of earnings over a period of years are included only in fully diluted computations (giving effect to the higher earnings level) but only if dilution results.

When contingent shares have been included in an earnings per share computation, they continue to be included in the computations

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[44]Unless their time of issuance (see Interpretation 89) is prior to June 1, 1969 *and* the issuer makes election "b" of Opinion paragraph 46 *and* they were not considered residual securities under APB Opinion No. 9. Contingent shares meeting these three conditions are other potentially dilutive securities.

in following periods until the expiration of the term of the agreement providing for the contingent issuance of additional shares. However,
30, 40 contingent shares are excluded from the computations whenever their effect would be anti-dilutive.

62-64 Prior period primary and fully diluted earnings per share should be retroactively restated whenever the number of shares issued or contingently issuable changes from the number of shares originally included in the computation. However, prior period earnings per share
62 data are not retroactively restated for shares actually issued when the condition was the attainment of specified increased earnings levels and the shares were not previously considered outstanding.

89. Time of Issuance for Contingent Issuances

Q—What is the time of issuance of a contingently issuable security?

29 A—The time of issuance of a contingently issuable security is the date when agreement to terms has been reached and announced even though subject to further actions, such as directors' or stockholders' approval. But, contingently issuable common stock is considered outstanding for earnings per share computations only when the terms become binding. (See Interpretations 27 and 28.)

90. Market Price Conditions

Q—How do market price conditions affect the number of contingent shares included in earnings per share computations?

A—The number of contingently issuable shares may depend on
63, 64 market prices for an issuer's common stock. Generally, these market price conditions for contingent shares may be classified as (1) maximum future market price guarantees, (2) market prices for base number of shares to be determined, and (3) minimum future market price guarantees. Additionally, some agreements based on market prices for an issuer's common stock specify that no less than some minimum number of shares and/or no more than some maximum number of shares will be issued regardless of market prices.

Conditions which guarantee a maximum future price provide "upside" assurance. That is, the issuer guarantees that the market price per share will increase to some stated amount within some time period. To the extent that the market price does not increase as guaranteed, the issuer agrees to issue additional shares or pay cash to make up the difference. Such a guarantee may extend to shares already issued as well as shares to be issued.

Conditions for market prices to determine the base number of shares to be issued may relate to periodic prices (such as the end of each year), an average of prices over some period, or some final price (such as at the end of five years). The conditions may also specify maximum or minimum market price guarantees.

Conditions which guarantee a minimum future price provide "downside" protection. That is, the issuer guarantees that the market price per share will not decrease below some stated amount within some time period. To the extent that the market price goes below that amount, the issuer agrees to issue additional shares or pay cash to make up the difference. Such a guarantee may extend to shares already issued as well as to shares to be issued.

When the number of contingently issuable shares depends on the future market price of an issuer's common stock, earnings per share computations reflect the number of shares which would be issuable based on the market price at the close of the period being reported upon. If a minimum and/or maximum number of shares is also specified, the number of shares determined from the market price at the close of the period would, if necessary, be adjusted to not less than the minimum nor more than the maximum number of shares so specified.

When additional shares are to be issued for an "upside" or a "downside" guarantee and the market price at the close of the period is less than the guaranteed price, earnings per share computations should give effect to the additional shares which would be issued.

The number of contingently issuable shares may differ for primary
and fully diluted computations based upon earnings levels. But market 62
price conditions do not cause different numbers of contingently issuable
shares to be included in primary and fully diluted computations. Spe-
cifically, more shares are not included in fully diluted than in primary 63, 64
computations because of market price guarantees. A market price
guarantee has the same effect on both computations.

Prior period earnings per share would be retroactively restated if the number of shares issued or contingently issuable subsequently changes because of market price changes.

91. Earnings Conditions

Q—How does an earnings condition affect the number of contingent shares included in earnings per share computations?

62, 64 A—Earnings conditions for the contingent issuance of common stock vary. Some earnings conditions determine the *total* number of shares to be issued, for example, one share for each $100 earned (1) each year for five years or (2) based on a formula, such as ten times the average annual earnings for five years.

Other earnings conditions determine the *additional* number of shares to be issued. Typically, additional shares are to be issued based on either (1) the *maintenance* of (a) the present level of earnings or (b) a higher level of earnings or (2) the *attainment* of (a) a higher level of earnings or (b) successively higher levels of earnings.

Earnings conditions may specify a minimum and/or a maximum number of shares to be issued regardless of earnings. Shares may be issued each year or only at the end of several years. Earnings conditions may apply to each year individually or may apply to all years on some cumulative or average basis. Various combinations of the earnings conditions described above may be contained in an agreement.

Some maximum number of shares may be issued initially (or
61 placed in escrow) with the stipulation that unearned shares are to be returned to the issuer. Such plans specifying that shares are returnable are treated the same as contingently issuable shares for earnings per share computations.

Because of the diversity of earnings conditions, stating general guidelines which will apply to all agreements is difficult. The number of shares included in earnings per share computations for an earnings agreement should conform to the provisions of Opinion paragraphs 62 and 64 and to the guidelines given below.

62, 64 If shares would at some time be issuable based on the present level of earnings, the shares issuable based on that level of earnings projected to the end of the agreement are considered outstanding for both primary and fully diluted computations. If shares previously considered outstanding become unissuable (for example, because of a decline in earnings), previously reported earnings per share data would be retroactively restated when the term of the condition expires and it is determined that the shares will not be issued.

If additional shares would at some time be issuable if a level of earnings higher than the present level were attained, the additional shares issuable based on the higher level (or levels) projected to the end of the agreement are considered outstanding only for the fully diluted computation, giving effect to the higher earnings level. If different levels of earnings are specified, the level which results in the greatest dilution is used. If additional shares previously considered outstanding become unissuable (for example, because the higher earnings level is not maintained), previously reported earnings per share data would be retroactively restated when it is determined that the shares will not be issued. If in giving effect to the higher earnings level dilution does not result, the additional shares are not included in the computation. When such additional shares were not included in prior earnings per share computations but are subsequently issued (for example, because the higher earnings level was actually attained), previously reported earnings per share data are *not* retroactively restated.

When an earnings condition specifies a minimum and/or a maximum number of shares to be issued, no less than the minimum nor no more than the maximum number specified would be included in the earnings per share computations. If shares are issued each year and a total minimum and/or maximum number is specified, the minimum and/or maximum would be reduced by the number of shares issued.

92. Convertible Securities Contingently Issuable

Q—How are contingently issuable convertible securities treated for earnings per share computations?

A—Contingently issuable convertible securities are included in earnings per share computations under the guidelines described for
convertible securities and the guidelines described for contingently 33, 51
issuable common stock. That is, additional convertible securities are
assumed to be issued in conformity with the conditions specified for 61-64
their issuance. (See Interpretatitons 88-91 for an explanation of how conditions affect the number of securities considered outstanding.)

29 Time of issuance of the contingently issuable convertible securities is the date when agreement as to terms has been reached and announced. The classification of the contingently issuable convertible security as a common stock equivalent or other potentially dilutive security is determined at time of issuance based on its yield at that time[45] and does not change when the security is actually issued. A change in the bank prime interest rate or the market price of the security between the time of issuance and actual issuance of a contingently issuable convertible security has no effect on its classification.[46]

Those contingently issuable convertible securities classified as
33 common stock equivalents are included in both primary and fully
diluted computations. However, such common stock equivalents
62 based on the attainment or maintenance of earnings above the present
level are included only in fully diluted computations. Contingently
issuable convertible securities classified as other potentially dilutive
securities are included only in fully diluted computations.

When contingently issuable convertible securities are to be included
51 in earnings per share computations, conversion of the additional securities is assumed. However, conversion is not assumed for the additional securities unless conversion is also assumed for their counterpart outstanding convertible securities. Interest or dividends are not imputed for the additional contingently issuable convertible securities since any imputed amount would be reversed by the if converted adjustments for assumed conversion.

PARENT AND CONSOLIDATED FINANCIAL STATEMENTS

93. Securities Issued by Subsidiaries

Q—How do convertible securities and options and warrants issued by a subsidiary affect parent and/or consolidated earnings per share?

65 A—The effect of options and warrants and convertible securities issued by a subsidiary upon consolidated earnings per share (or parent company earnings per share when parent company statements are

[45]Unless it has the same terms as the terms of an outstanding convertible security which is a common stock equivalent. A convertible security contingently issuable at May 31, 1969 would be classified under either election "a" or election "b" of Opinion paragraph 46.

[46]Except in the situations described in Interpretations 29 and 30.

prepared as the primary financial statements using the equity method) depends upon whether the securities issued by the subsidiary to the public enable their holders to obtain common stock of the subsidiary company or common stock of the parent company.

Securities issued by a subsidiary which enable their holders to obtain the subsidiary's common stock are included in computing the 66-67
subsidiary's earnings per share data. These earnings per share data are then included in the parent or consolidated earnings per share computations based on the consolidated group's holdings of the subsidiary's securities.

Options and warrants issued by a subsidiary which enable their holders to purchase parent company common stock are common stock 68-69
equivalents[47] for parent or consolidated earnings per share computations. Securities of a subsidiary convertible into parent company common stock are classified as common stock equivalents or other potentially dilutive securities for parent or consolidated earnings per share computations under the yield test.[48]

The following example illustrates the earnings per share computations for a subsidiary's securities which enable their holders to obtain the subsidiary's common stock. Assume that a parent corporation had 66-67
a net income of $10,000 from operations (excluding any dividends paid by the subsidiary), had 10,000 shares of common stock outstanding and had not issued any other securities. The parent corporation owned 900 of the common shares of a domestic subsidiary corporation and also owned 40 warrants and 100 shares of convertible preferred stock issued by the subsidiary. The subsidiary corporation had a net income of $3,600 and had outstanding 1,000 shares of common stock, 200 warrants exercisable to purchase 200 shares of its common at $10 per share (assume $20 average and ending market price for common), and 200 shares of preferred stock convertible into two of its common shares for each preferred share. The convertible preferred paid a dividend of $1.50 per share and is not a common stock equivalent. Assume that no intercompany eliminations or adjustments are necessary except for dividends. (Income taxes have been ignored in the following computations for simplicity.)

[47]Unless issued prior to June 1, 1969 and the parent company makes election "b" specified by Opinion paragraph 46.

[48]See Interpretation 45 for a description of the treatment of a subsidiary security convertible into a parent company's convertible security.

Earnings per share for the subsidiary

Primary earnings per share \$3.00

Computed:

$$\frac{\$3{,}600^{a} - \$300^{b}}{1{,}000^{c} + 100^{d}}$$

[a]Subsidiary's net income.
[b]Dividends paid by subsidiary on convertible preferred stock.
[c]Shares of subsidiary's common stock outstanding.
[d]Incremental shares of subsidiary's common stock assumed outstanding applying the treasury stock method for warrants (computed $\frac{\$20-\$10}{\$20} \times 200$).

Fully diluted earnings per share \$2.40

Computed:

$$\frac{\$3{,}600^{e}}{1{,}000 + 100 + 400^{f}}$$

[e]Subsidiary's earnings applicable to common stock applying the if converted method for convertible preferred stock.
[f]Shares of subsidiary's common stock assumed outstanding from conversion of convertible preferred stock.

Parent or consolidated earnings per share

66 Primary earnings per share \$1.29

Computed:

$$\frac{\$10{,}000^{a} + \$150^{b} + \$2{,}700^{c} + \$60^{d}}{10{,}000^{e}}$$

[a]Parent's net income.
[b]Dividends received by parent on subsidiary's convertible preferred stock.
[c]Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: $\frac{900}{1{,}000}$ (1,000 shares $\times$ \$3 per share).
[d]Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: $\frac{40}{200}$ (100 incremental shares $\times$ \$3 per share).
[e]Shares of parent's common stock outstanding.

Fully diluted earnings per share $1.27 67

Computed:

$$\frac{\$10{,}000 + \$2{,}160^{f} + \$48^{g} + \$480^{h}}{10{,}000}$$

[f]Parent's proportionate interest in subsidiary's earnings attributable to common stock, computed: $\frac{900}{1{,}000}$ (1,000 shares × $2.40 per share).

[g]Parent's proportionate interest in subsidiary's earnings attributable to warrants, computed: $\frac{40}{200}$ (100 incremental shares × $2.40 per share).

[h]Parent's proportionate interest in subisdiary's earnings attributable to convertible preferred stock, computed:

$\frac{100}{200}$ (400 shares from conversion × $2.40 per share).

The above computations apply only to earnings per share data.
Parent or consolidated net income is determined in the usual manner 39
as follows:

Parent net income from operations				$10,000
Subsidiary net income			$3,600	
Less minority interest:				
	Preferred	$150[i]		
	Common	330[j]	480	3,120
Parent or consolidated net income				$13,120

Computed:

[i]50% (200 preferred shares × $1.50 dividend per share).
[j]10% ($3,600 net income — $300 preferred dividends).

Note that parent or consolidated net income is not the basis for parent or consolidated earnings per share computations.

68-69 These computations would be different if the subsidiary's securities could be exercised or converted only to obtain the parent company's common stock. For example, assume the same facts as were given in the preceding illustration except (1) the warrants and convertible securities are all owned by outsiders, (2) the subsidiary's warrants are exercisable only to obtain parent company common stock, and (3) the subsidiary's preferred stock is convertible only into parent company common stock.

Earnings per share for the subsidiary

Primary earnings per share $3.30

Computed:

$$\frac{\$3{,}600 - \$300}{1{,}000}$$

Fully diluted earnings per share $3.30

Computed:

$$\frac{\$3{,}600 - \$300}{1{,}000}$$

Parent or consolidated earnings per share

Primary earnings per share $1.28 68

Computed:

$$\frac{\$10{,}000^{a} + \$2{,}970^{b}}{10{,}000^{c} + 100^{d}}$$

[a]Parent's net income.

[b]Parent's proportionate interest in subsidiary's earnings attributable to common stock; computed: $\frac{900}{1{,}000}$ (1,000 shares $\times$ \$3.30 per share).

[c]Shares of parent's common stock outstanding.

[d]Incremental shares of parent's common stock assumed outstanding applying the treasury stock method for warrants issued by subsidiary exercisable to obtain parent's common stock (computed $\frac{\$20 - \$10}{\$20} \times 200$).

Fully diluted earnings per share $1.26 69

Computed:

$$\frac{\$10{,}000 + \$2{,}970 + \$300^{e}}{10{,}000 + 100 + 400^{f}}$$

[e]Dividends paid by subsidiary on convertible preferred stock which would not have been received by outsiders if the subsidiary's preferred stock had been converted into parent's common stock at the beginning of the period.

[f]Shares of parent's common stock assumed outstanding from conversion of subsidiary's preferred stock convertible into parent's common stock.

Parent or consolidated net income would be determined as follows: 39

Parent net income from operations			$10,000
Subsidiary net income		$3,600	
Less: Dividends on preferred stock	$300		
Minority common interest (10%)	330	630	2,970
Parent or consolidated net income			$12,970

Note that parent or consolidated net income is not the basis for parent or consolidated earnings per share computations.

EFFECTS OF SCHEDULED CHANGES

94. Changing Exercise Prices and Conversion Rates

Q—How do changes which may occur in exercise prices or conversion rates affect earnings per share computations?

A—Except as discussed in the next paragraph, if an exercise price
57 or conversion rate is in effect during a period, that exercise price or
conversion rate is used for primary computations. When no exercise
price or conversion rate is in effect during a period, the earliest effective exercise price or conversion rate during the following five years
58 is used for primary computations. The most advantageous exercise
price or conversion rate available to the holder within ten years is
always used for fully diluted computations. Previously reported earn-
57 ings per share data are not restated for subsequent changes in the
conversion rate or exercise price.

If a convertible security having an increasing conversion rate is issued in exchange for another class of security of the issuing company and is at some time convertible back into as many of the same or a similar security as was exchanged, the conversion rate used in the computation does not result in a reduction of the number of common shares (or common stock equivalents) existing before the exchange.

For example, assume that a corporation issued 100,000 shares of convertible preferred to officers and principal stockholders in exchange for 300,000 shares of common stock and each preferred share is convertible back into one common share the first year, two common shares the second year, three common shares the third year, and four common shares the fourth year and thereafter. The convertible preferred would be included as 300,000 common equivalent shares for primary earnings per share computations and 400,000 common equivalent shares for fully diluted earnings per share computations for the first three years and 400,000 common equivalent shares thereafter for both computations.

ELECTION TO CLASSIFY OUTSTANDING SECURITIES

95. Factors in Paragraph 46 Election

Q—What factors would be considered in classifying securities issued prior to June 1, 1969 under the elections provided in Opinion paragraph 46?

A—The following factors might be considered for elections "a" and "b" provided in Opinion paragraph 46: 46

1. The Opinion recommends restatement of prior periods' earnings per share data if election "b" is made and such data are included in financial statements issued after May 31, 1969, e.g., included in a comparative income statement. Restatement is not required under election "b." Although retroactive restatement is recommended, restatement may not greatly change previously reported earnings per share data. Such data therefore could be included in a comparative income statement without restatement and without a significant loss of comparability.

If election "a" is made, however, all prior periods' earnings per share data must be retroactively recomputed and restated under the provisions of APB Opinion No. 15 when prior periods' data are subsequently presented.

2. APB Opinion No. 15 includes all options and warrants as common stock equivalents and establishes a test at issuance for convertible securities to determine their classification as common stock equivalents or not. APB Opinion No. 9 excluded the effect of options and warrants from the first EPS amount (unless they were classified as residual securities) and allowed a convertible security to move from senior security to residual status and vice versa based on the value of its conversion rights and common stock characteristics.

Therefore, election "b" would generally exclude options and warrants issued before May 31, 1969 from primary earnings per share computations. Election "a," on the other hand, would cause convertible securities classified as residual under APB Opinion No. 9 at May 31, 1969 which would not be common stock equivalents at issuance under APB Opinion No. 15 to be reclassified as other potentially dilutive securities. If a corporation had options and warrants and convertible securities as described above, the effects of both types of securities would probably be considered in determining the election to be made.

96. Effect of New Issue of Common Stock Equivalents

Q—When securities are classified under election "b" of Opinion paragraph 46, can the classifications of those securities change in the future?

46 A—Generally, the classification of a security does not change after
either election is made. However, convertible securities issued before
June 1, 1969 would change from other potentially dilutive security
status to common stock equivalent status if another convertible
28 security is issued with the same terms which is a common stock
equivalent as specified by the second sentence of Opinion paragraph
28. (See Interpretation 30.)

97. No Change for Options and Warrants

Q—Would outstanding options or warrants issued prior to June 1, 1969 classified as non-residual securities under election "b" of Opinion paragraph 46 become common stock equivalents under the second sentence of Opinion paragraph 28 if another option or warrant were issued with the same terms after May 31, 1969?

28 A—No, such a change of classification applies only to convertible securities. Although this creates a difference of treatment between convertible securities and options and warrants, the Board was explicit in naming only convertible securities.

Because warrants are often traded, identification of a warrant being exercised as having been issued "before" or "after" may be impossible. When an exercised warrant cannot definitely be identified as having been issued after May 31, 1969, exercise is assumed on a FIFO basis. That is, the first warrants issued are assumed to be the first exercised when specific identification is impossible. The same treatment applies for options, except options usually are not transferable and the specific option being exercised can usually be identified.

98. Prior Period Restatement Recommended

Q—Must earnings per share reported under the provisions of APB Opinion No. 9 be restated under the provisions of APB Opinion No. 15?

A—When election ‘b” of Opinion paragraph 46 is made, the
Opinion recommends that earnings per share amounts previously 45
reported under APB Opinion No. 9 be restated so the previously
outstanding securities conform to the classifications determined under
election “b” when such amounts are reported in comparative income
statements and election “b” applies to at least one period in the
statement. To the extent that the Opinions differ, following this
recommendation will have the effect of retroactively restating previ-
ously reported earnings per share amounts.

If election “a” of paragraph 46 is made, APB Opinion No. 15 46
must be applied for all periods presented.

If election “b” of paragraph 46 is made, some companies might prefer not to restate previously reported earnings per share amounts and such restatement is not required by APB Opinion No. 15. There may be cases, however, where the corporation or its auditor may believe that disclosure of the restated earnings per share data is particularly appropriate.

99. Is Prior Period Restatement Permitted?

Q—May prior period earnings per share amounts be retroactively restated other than when restatement is required, for example, for changes in the number of shares computed under the treasury stock method or when a convertible security being issued is determined to be a common stock equivalent and causes outstanding convertible securities with the same terms which were not common stock equivalents at issuance to also become common stock equivalents?

A—No, previously reported earnings per share amounts generally
are retroactively restated only when restatement is required (see
Part I, page 11). Earnings per share data are not restated because of 36
changes in the number of shares computed under the treasury stock
method. Nor should primary earnings per share data be restated when 28
a convertible security's classification changes because of the subsequent
issuance of another convertible security with the same terms.

DISCLOSURE

100. Required Disclosure

Q—What information related to earnings per share is required to be disclosed in addition to earnings per share data?

A—APB Opinion No. 15 requires disclosure of the following information:

18 1. Restatement for a prior period adjustment.
19 2. Dividend preferences.
3. Liquidation preferences.
4. Participation rights.
5. Call prices and dates.
6. Conversion rates and dates.
7. Exercise prices and dates.
8. Sinking fund requirements.
9. Unusual voting rights.
20 10. Bases upon which primary and fully diluted earnings per
21 share were calculated. (The computations would not, however, appear upon the face of the income statement.)
20 11. Issues which are common stock equivalents.
12. Issues which are other potentially dilutive securities.
13. Assumptions and adjustments made for earnings per share data.
14. Shares issued upon conversion, exercise, and conditions met for contingent issuances.
23 15. Recapitalization occurring during the period or before the statements are issued.
48 16. Stock dividends, stock splits or reverse splits occurring after the close of the period before the statements are issued.
50 17. Claims of senior securities entering earnings per share computations.
70 18. Dividends declared by the constituents in a pooling.
19. Basis of presentation of dividends in a pooling on other than a historical basis.
fn. 16 20. Per share and aggregate amount of cumulative preferred dividends in arrears.

101. Supplementary Data

Q—When must supplementary earnings per share data be furnished?

A—Supplementary earnings per share data must be furnished for the latest period when common stock is issued on conversion during the period or after the close of the period before the report is issued if primary earnings per share would have increased or decreased at least 3% if the issuance had occurred at the beginning of the period. It may also be desirable to furnish supplementary earnings per share data for each period presented giving the cumulative retroactive effect of all such issuances, but primary earnings per share as reported in those periods should not be retroactively adjusted. 22, fn. 2, 22

Supplementary earnings per share data generally would also be furnished whenever common stock or common stock equivalents have been sold for cash and the proceeds have been or are to be used to retire preferred stock or debt. The supplementary data would be furnished even though the sale occurred shortly after the close of the period but before completion of the financial report. 23

When the issuance of a convertible security classified as a common stock equivalent causes outstanding convertible securities with the same terms classified as other potentially dilutive securities to be reclassified as common stock equivalents, supplementary earnings per share data may be useful to explain the change in classification. The supplementary data would show what previously reported primary earnings per share would have been if the convertible securities had been classified as common stock equivalents since issuance and thus reconstruct the primary earnings trend. Previously reported primary earnings per share would not be retroactively restated for prior periods in a comparative income statement because of such a change in classification. 28, 22

EXHIBIT 1

DESCRIPTION OF UNOFFICIAL ACCOUNTING INTERPRETATION SERVICE

Reprinted from *The CPA*, September 1969, Page 6

from the Executive Vice President

LEONARD M. SAVOIE

Unofficial Accounting Interpretations:
an Institute service to the profession

The need for timely and consistent explanations of what constitutes good accounting practice has long been recognized by the Institute. The many Institute activities dedicated to this objective give evidence of this recognition. Since its inception the Accounting Principles Board has assumed the major responsibility for issuing authoritative statements on accounting principles through its official Opinions. It has increased its production of Opinions and is effectively fulfilling its responsibility.

Most subjects considered by the Board are controversial, thus requiring time for research and study by Board members. In spite of the dedication of Board members and their commitment to an unbelievable workload, there are more issues remaining to be treated in Opinions than have been dealt with thus far. Furthermore, an APB Opinion does not solve all problems; in fact, a new Opinion often opens up new areas calling for interpretation.

Audit guides and the pronouncements of other Institute technical committees often deal with questions which relate to matters of accounting principles in a specific area and may require interpretation.

In areas not covered by existing pronouncements, situations frequently arise where inconsistent practices seem likely unless the profession is guided into a preferable position. In such cases there may not be enough time for formal APB consideration.

All of these conditions point up the need for a timely informal interpretive service to provide guidance as to preferred accounting practices.

In response to this need, the executive committee with the APB's concurrence early this year authorized the staff to issue Unofficial Accounting Interpretations. Although the interpretations are to be issued without the formal procedures required for an APB Opinion, each interpretation must be approved for release by the executive vice president of the Institute and by the chairman of the Accounting Principles Board. The objective is to provide interpretations which will be sound and in conformity with the APB's intent when they relate to an Opinion. The interpretations will not be the personal views of the staff as to what an Opinion *should* have said but rather a statement of what the APB intended, based on records of the Board's deliberation and discussion with individual Board members. At times the Board itself may consider the issue and advise the staff in arriving at the interpretive position.

After the interpretation service was authorized, J. T. Ball, then the Institute's assistant director of examinations, was selected to fill the newly created position of research associate for accounting interpretations upon the completion of his duties for the May 1969 CPA examination. Mr. Ball will undertake the necessary research and consultation with informed members of the profession who have extensive experience in the problem areas to define the issues and arrive at tentative conclusions. He will prepare interpretations under the supervision of Richard C. Lytle, administrative director of the APB.

The interpretations are being published initially in the Accounting and Auditing Problems section of *The Journal of Accountancy*. (See JofA, July 69, p. 67 and Sept. 69, p. 70.) Plans are underway to integrate them into the loose-leaf edition of *APB Accounting Principles* in a section separate from Opinions but with co-ordinated indexing. Should the APB issue an Opinion on matters included in an Unofficial Accounting Interpretation, the superseded material would be withdrawn immediately.

The interpretation service will provide guidance on questions having general interest to the profession and will not respond to individual inquiries about specific accounting questions; *all individual inquires should continue to be directed to the Institute's Technical Information Service.* Naturally, some TIS inquiries will probably point to the need for Unofficial Accounting Interpretations.

Although the interpretations are unofficial and tentative, they will be considered by the Institute to express preferred practices in the areas of financial reporting to which they relate. In view of the procedures under which the interpretations are to be developed and approved, Unofficial Accounting Interpretations may be relied upon by members of the profession in the absence of other authoritative pronouncements. We believe that this timely guidance will be greatly welcomed by all practicing CPAs.

EXHIBIT 2

U. S. BANK PRIME INTEREST RATES

(Source: Federal Reserve Bulletin)

Effective Date		*Prime Rate (%)*	*66 2/3% of Prime Rate (%)*
1954	January 1	3.25	2.17
	March 17	3.00	2.00
1955	August 4	3.25	2.17
	October 14	3.50	2.33
1956	April 13	3.75	2.50
	August 21	4.00	2.67
1957	August 6	4.50	3.00
1958	January 22	4.00	2.67
	April 21	3.50	2.33
	September 11	4.00	2.67
1959	May 18	4.50	3.00
	September 1	5.00	3.33
1960	August 23	4.50	3.00
1965	December 6	5.00	3.33
1966	March 10	5.50	3.67
	June 29	5.75	3.83
	August 16	6.00	4.00
1967	January 26-27	5.75(1)	3.83
	March 27	5.50	3.67
	November 20	6.00	4.00
1968	April 19	6.50	4.33
	September 25	6.25(2)	4.17
	November 13	6.25	4.17
	December 2	6.50	4.33
	December 18	6.75	4.50
1969	January 7	7.00	4.67
	March 17	7.50	5.00
	June 9	8.50	5.67
1970	February 25	8.50(3)	5.67
	March 25-26	8.00(4)	5.33

Notes:

(1) 5.75% predominant rate with 5.50% in effect at some banks.
(2) 6.25% predominant rate with 6% in effect at some banks.
(3) 8.50% predominant rate. Starting on February 25, 1970, however, and on several days thereafter, several small banks reduced their prime rates to 8%. At least one bank announced a 7½% prime rate. (See Interpretation 38.)
(4) Many major banks reduced their prime rates to 8% on March 25 and others followed on March 26. The 8% rate was the predominant rate in effect the date this table was prepared (May 6, 1970).

EXHIBIT 3

EXAMPLES OF COMPUTING AVERAGE MARKET PRICES

An average market price may be computed various ways in applying the treasury stock method for options and warrants. (See Interpretations 53 and 54.) In first applying the treasury stock method, the computation depends upon the stability of the market price of the common stock.

In the following example, an average market price has been computed eight different ways for one quarter. First, the computation is based upon weekly prices. The weekly prices are then averaged to determine a monthly average, which is then averaged to determine a quarterly average. (Although not illustrated, a quarterly average could also be computed by adding weekly prices and dividing by 13, thereby eliminating the computation of a monthly average.) In the second example, the computation is based upon monthly prices.

The "High-Low" computation is based upon an average of the high and low prices for the week or month. In the weighted averages, the market prices are weighted by the number of shares involved in the transactions.

Assume the following market transactions for a corporation's common stock during a three-month period:

	Week	*High*	*Low*	*Close*	*Shares Traded*
Month 1	1	21	19	20	300
	2	24	20	23	700
	3	24	22	22	500
	4	23	21	21	500
Month 2	5	26	22	23	1,000
	6	27	23	26	1,200
	7	29	27	28	1,500
	8	31	29	31	2,000
Month 3	9	28	26	26	2,500
	10	26	22	23	1,500
	11	24	22	22	1,000
	12	22	20	21	800
	13	20	20	20	500

EXHIBIT 3

Computing quarterly average from monthly averages based on weekly prices:

	Simple Averages		Weighted Averages		
Week	*High-Low*	*Close*	*Shares*	*High-Low*	*Close*
1............	20	20	300	6,000	6,000
2............	22	23	700	15,400	16,100
3............	23	22	500	11,500	11,000
4............	22	21	500	11,000	10,500
Month 1 totals	87	86	2,000	43,900	43,600
Divide by	4	4		2,000	2,000
Month 1 averages	21.75	21.50		21.95	21.80
5............	24	23	1,000	24,000	23,000
6............	25	26	1,200	30,000	31,200
7............	28	28	1,500	42,000	42,000
8............	30	31	2,000	60,000	62,000
Month 2 totals	107	108	5,700	156,000	158,200
Divide by	4	4		5,700	5,700
Month 2 averages	26.75	27.00		27.37	27.75
9............	27	26	2,500	67,500	65,000
10............	24	23	1,500	36,000	34,500
11............	23	22	1,000	23,000	22,000
12............	21	21	800	16,800	16,800
13............	20	20	500	10,000	10,000
Month 3 totals	115	112	6,300	153,300	148,300
Divide by	5	5		6,300	6,300
Month 3 averages	23.00	22.40		24.33	23.54
Three month total	71.50	70.90		73.65	73.09
Divide by	3	3		3	3
Three month average	23.83	23.63		24.55	24.36

Computing quarterly averages from monthly prices:

	Simple Averages		*Weighted Averages*		
	High-Low	*Close*	*Shares*	*High-Low*	*Close*
Month 1	21.50	21.00	2,000	43,000	42,000
Month 2	26.50	31.00	5,700	151,050	176,700
Month 3	24.00	20.00	6,300	151,200	126,000
Quarterly total	72.00	72.00	14,000	345,250	344,700
Divided by	3	3		14,000	14,000
Quarterly average ..	24.00	24.00		24.66	24.62

Assuming an exercise price of $20 for options or warrants to purchase 10,000 shares, the above average market prices would produce the following incremental shares:

	Simple Averages		*Weighted Averages*	
	High-Low	*Close*	*High-Low*	*Close*
Weekly prices	1,607	1,536	1,853	1,790
Monthly prices	1,667	1,667	1,890	1,877

Note: Computed

$$10{,}000 - \left(\frac{\$20 \times 10{,}000}{\text{average price}} \right) = \text{incremental shares}$$

EXHIBIT 4

APPLICATION OF THE TREASURY STOCK METHOD FOR OPTIONS AND WARRANTS

Assume 100,000 common shares are outstanding and 10,000 warrants are outstanding which are exercisable at $20 per share to obtain 10,000 common shares. Assume also the following market prices for common stock during a three-year period:

Market Prices Per Share of Common Stock

	Year 1		*Year 2*		*Year 3*	
Quarter	*Average*	*Ending*	*Average*	*Ending*	*Average*	*Ending*
1..........	$18*	$22	$24	$25	$20	$18
2..........	20*	21	22	21	18	22
3..........	22	19	20	19	24	21
4..........	24	23	18	17	22	25

* Assume market prices had been more than $20 for substantially all of a previous quarter.

Computation of Number of Incremental Shares by Quarters

Primary Earnings Per Share(1)

Quarter	*Year 1*	*Year 2*	*Year 3*
1..................	—0—	1,667	—0—
2..................	—0—	909	—0—
3..................	909	—0—	1,667
4..................	1,667	—0—	909

Fully Diluted Earnings Per Share

Quarter	*Year 1*	*Year 2*	*Year 3*
1..................	909(2)	2,000(2)	—0—
2..................	476(2)	909(1)	909(2)
3..................	909(1)	—0—	1,667(1)
4..................	1,667(1)	—0—	2,000(2)

(1) Based on average market price

(2) Based on ending market price

Note: Computed $\left(\dfrac{\text{Market Price—Exercise Price}}{\text{Market Price}}\right) \times 10{,}000 =$ Incremental Shares

EXHIBIT 4

Number of Incremental Shares Included in Year-to-Date Weighted Average

Primary Earnings Per Share(1)

	Year 1	Year 2	Year 3
First quarter	—0—	1,667	—0—
Six months	—0—	1,288	—0—
Nine months	303	859	556
Year	644	644	644

Fully Diluted Earnings Per Share

	Year 1	Year 2	Year 3
First quarter	909(1)	2,000(1)	—0—(1)
Six months	693(1)	1,455(1)	909(2)
Nine months	765(1)	970(1)	859(1)
Year	1,304(2)	727(1)	2,000(2)

(1) Computed by adding incremental shares of each quarter included and dividing by number of quarters included in the year-to-date.
(2) Incremental shares for all quarters included based on ending market price.

EXHIBIT 5

DAYS BETWEEN TWO DATES

The table on page 116 is useful in computing a weighted average of shares outstanding when the number of shares outstanding changes frequently during the year. The table includes numbered days for two years; one day must be added after February 28 during leap year. Corporations reporting on a calendar year basis should use the first 366 numbers; all other corporations should use both tables.

Since the number of days between two dates is determined by subtraction, the number used for the last day of the year is the first day of the following year. That is, a corporation reporting on a calendar year having a stock transaction on June 20 should weight the shares outstanding before the transaction by 170 (determined 171 − 1 = 170) and the shares outstanding after the transaction by 195 (determined 366 − 171 = 195). The 170 days before plus the 195 days after then equal 365 days. For leap year, corresponding computations would be 172 − 1 = 171 and 367 − 172 = 195, so 171 + 195 = 366.

An example of how to use the table follows. Assume a corporation reports on a fiscal year ending June 30. At July 1, 1969 the corporation had 100,000 shares of common stock outstanding. On August 25, 1969 the corporation distributed a 5% stock dividend to its shareholders. On September 18, 1969 the corporation purchased 525 shares of its stock. On April 8, 1970 the corporation issued 10,000 shares of its stock for cash. On May 21, 1970 the corporation split its stock 2-for-1.

The days to be used for weighting are:

Transaction Day	*Number for Transaction Day*	*Number for Beginning Day*	*Days for Weighting*
September 18, 1969	261	182	79
April 8, 1970	463	261	202
End of year	547	463	84
Total days			365

The August 25, 1969 stock dividend and the May 21, 1970 stock split are reflected retroactively in the weighted average of shares outstanding as computed below:

EXHIBIT 5

Date	Shares		Stock Dividend[49]	Stock Split[49]	Days Outstanding	Weighted Shares
7/ 1/69	outstanding	100,000	× 1.05 = 105,000	× 2 = 210,000 ×	79	= 16,590,000
9/18/69	purchase	(525)		× 2 = (1,050)		
				208,950 ×	202	= 42,207,900
4/ 8/70	issue	10,000		× 2 = 20,000		
				228,950 ×	84	= 19,231,800
Totals					365	78,029,700

Weighted average number of shares outstanding:

$$\frac{78{,}029{,}700}{365} = 213{,}780$$

[49]Note that stock dividends and stock splits are retroactive adjustments rather than transactions to be weighted by the number of days a stock dividend or split was outstanding.

EXHIBIT 5

TABLE OF DAYS BETWEEN TWO DATES

Day in Month	January	February	March	April	May	June	July	August	September	October	November	December
1	1	32	60	91	121	152	182	213	244	274	305	335
2	2	33	61	92	122	153	183	214	245	275	306	336
3	3	34	62	93	123	154	184	215	246	276	307	337
4	4	35	63	94	124	155	185	216	247	277	308	338
5	5	36	64	95	125	156	186	217	248	278	309	339
6	6	37	65	96	126	157	187	218	249	279	310	340
7	7	38	66	97	127	158	188	219	250	280	311	341
8	8	39	67	98	128	159	189	220	251	281	312	342
9	9	40	68	99	129	160	190	221	252	282	313	343
10	10	41	69	100	130	161	191	222	253	283	314	344
11	11	42	70	101	131	162	192	223	254	284	315	345
12	12	43	71	102	132	163	193	224	255	285	316	346
13	13	44	72	103	133	164	194	225	256	286	317	347
14	14	45	73	104	134	165	195	226	257	287	318	348
15	15	46	74	105	135	166	196	227	258	288	319	349
16	16	47	75	106	136	167	197	228	259	289	320	350
17	17	48	76	107	137	168	198	229	260	290	321	351
18	18	49	77	108	138	169	199	230	261	291	322	352
19	19	50	78	109	139	170	200	231	262	292	323	353
20	20	51	79	110	140	171	201	232	263	293	324	354
21	21	52	80	111	141	172	202	233	264	294	325	355
22	22	53	81	112	142	173	203	234	265	295	326	356
23	23	54	82	113	143	174	204	235	266	296	327	357
24	24	55	83	114	144	175	205	236	267	297	328	358
25	25	56	84	115	145	176	206	237	268	298	329	359
26	26	57	85	116	146	177	207	238	269	299	330	360
27	27	58	86	117	147	178	208	239	270	300	331	361
28	28	59	87	118	148	179	209	240	271	301	332	362
29	29	..	88	119	149	180	210	241	272	302	333	363
30	30	..	89	120	150	181	211	242	273	303	334	364
31	31	..	90	...	151	...	212	243	...	304	...	365

Day in Month	January	February	March	April	May	June	July	August	September	October	November	December
1	366	397	425	456	486	517	547	578	609	639	670	700
2	367	398	426	457	487	518	548	579	610	640	671	701
3	368	399	427	458	488	519	549	580	611	641	672	702
4	369	400	428	459	489	520	550	581	612	642	673	703
5	370	401	429	460	490	521	551	582	613	643	674	704
6	371	402	430	461	491	522	552	583	614	644	675	705
7	372	403	431	462	492	523	553	584	615	645	676	706
8	373	404	432	463	493	524	554	585	616	646	677	707
9	374	405	433	464	494	525	555	586	617	647	678	708
10	375	406	434	465	495	526	556	587	618	648	679	709
11	376	407	435	466	496	527	557	588	619	649	680	710
12	377	408	436	467	497	528	558	589	620	650	681	711
13	378	409	437	468	498	529	559	590	621	651	682	712
14	379	410	438	469	499	530	560	591	622	652	683	713
15	380	411	439	470	500	531	561	592	623	653	684	714
16	381	412	440	471	501	532	562	593	624	654	685	715
17	382	413	441	472	502	533	563	594	625	655	686	716
18	383	414	442	473	503	534	564	595	626	656	687	717
19	384	415	443	474	504	535	565	596	627	657	688	718
20	385	416	444	475	505	536	566	597	628	658	689	719
21	386	417	445	476	506	537	567	598	629	659	690	720
22	387	418	446	477	507	538	568	599	630	660	691	721
23	388	419	447	478	508	539	569	600	631	661	692	722
24	389	420	448	479	509	540	570	601	632	662	693	723
25	390	421	449	480	510	541	571	602	633	663	694	724
26	391	422	450	481	511	542	572	603	634	664	695	725
27	392	423	451	482	512	543	573	604	635	665	696	726
28	393	424	452	483	513	544	574	605	636	666	697	727
29	394	...	453	484	514	545	575	606	637	667	698	728
30	395	...	454	485	515	546	576	607	638	668	699	729
31	396	...	455	...	516	...	577	608	...	669	...	730

APB Opinion No. 15:

EARNINGS PER SHARE

AICPA Accounting Principles Board

CONTENTS

INTRODUCTION

1. Earnings per share data are used in evaluating the past operating performance of a business, in forming an opinion as to its potential and in making investment decisions. They are commonly presented in prospectuses, proxy material and reports to stockholders. They are used in the compilation of business earnings data for the press, statistical services and other publications. When presented with formal financial statements, they assist the investor in weighing the significance of a corporation's current net income and of changes in its net income from period to period in relation to the shares he holds or may acquire.

2. In view of the widespread use of earnings per share data, it is important that such data be computed on a consistent basis and presented in the most meaningful manner. The Board and its predecessor committee have previously expressed their views on general standards designed to achieve these objectives, most recently in Part II of APB Opinion No. 9, *Reporting the Results of Operations.*

3. In this Opinion the Board expresses its views on some of the more specific aspects of the subject, including the guidelines that should be applied uniformly in the computation and presentation of earnings per share data in financial statements. Accordingly, this Opinion supersedes Part II (paragraphs 30-51) and Exhibit E of APB Opinion No. 9. In some respects, practice under APB Opinion No. 9 will be changed by this Opinion.

4. Computational guidelines for the implementation of this Opinion are contained in Appendix A. Certain views differing from those adopted in this Opinion are summarized in Appendix B. Illustrations of the presentations described in this Opinion are included in the Exhibits contained in Appendix C. Definitions of certain terms as used in this Opinion are contained in Appendix D.

APPLICABILITY

5. This Opinion applies to financial presentations which purport to present results of operations of corporations in conformity with generally accepted accounting principles and to summaries of those presentations, except as excluded in paragraph 6. Thus, it applies to corporations whose capital structures include only common stock or common stock and senior securities and to those whose capital structures also include securities that should be considered the equivalent of common stock[1] in computing earnings per share data.

6. This Opinion does not apply to mutual companies that do not have outstanding common stock or common stock equivalents (for example, mutual savings banks, cooperatives, credit unions, and similar entities); to registered investment companies; to government-owned corporations; or to nonprofit corporations. This Opinion also does not apply to parent company statements accompanied by consolidated financial statements, to statements of wholly owned subsidiaries, or to special purpose statements.

HISTORICAL BACKGROUND

7. Prior to the issuance of APB Opinion No. 9, earnings per share were generally computed by dividing net income (after deducting preferred stock dividends, if any) by the number of common shares outstanding. The divisor used in the computation usually was a weighted average of the number of common shares outstanding during the period, but sometimes was simply the number of common shares outstanding at the end of the period.

8. ARB No. 49, *Earnings per Share,* referred to "common stock or other residual security;" however, the concept that a security other than a common stock could be the substantial equivalent of common stock and should, therefore, enter into

1 APB Opinion No. 9 referred to certain securities as *residual* securities, the determination of which was generally based upon the market value of the security as it related to investment value. In this Opinion, the Board now uses the term *common stock equivalents* as being more descriptive of those securities other than common stock that should be dealt with as common stock in the determination of earnings per share.

the computation of earnings per share was seldom followed prior to the issuance of APB Opinion No. 9. Paragraph 33 of APB Opinion No. 9 stated that earnings per share should be computed by reference to common stock and other residual securities and defined a residual security as follows:

> "When more than one class of common stock is outstanding, or when an outstanding security has participating dividend rights with the common stock, or when an outstanding security clearly derives a major portion of its value from its conversion rights or its common stock characteristics, such securities should be considered 'residual securities' and not 'senior securities' for purposes of computing earnings per share."

9. APB Opinion No. 9 also stated in part (paragraph 43) that:

> "Under certain circumstances, earnings per share may be subject to dilution in the future if existing contingencies permitting issuance of common shares eventuate. Such circumstances include contingent changes resulting from the existence of (a) outstanding senior stock or debt which is convertible into common shares, (b) outstanding stock options, warrants or similar agreements and (c) agreements for the issuance of common shares for little or no consideration upon the satisfaction of certain conditions (e.g., the attainment of specified levels of earnings following a business combination). If such potential dilution is material, supplementary pro forma computations of earnings per share should be furnished, showing what the earnings would be if the conversions or contingent issuances took place."

Before the issuance of APB Opinion No. 9 corporations had rarely presented pro forma earnings per share data of this type except in prospectuses and proxy statements.

10. Under the definition of a residual security contained in paragraph 33 of APB Opinion No. 9, residual status of convertible securities has been determined using the "major-portion-of-value" test at the time of the issuance of the security and from time to time thereafter whenever earnings per share

data were presented. In practice this test has been applied by comparing a convertible security's market value with its investment value, and the security has been considered to be residual whenever more than half its market value was attributable to its common stock characteristics at time of issuance. Practice has varied in applying this test subsequent to issuance with a higher measure used in many cases. Thus, a convertible security's status as a residual security has been affected by equity and debt market conditions at and after the security's issuance.

11. Application of the residual security concept as set forth in paragraph 33 of APB Opinion No. 9 has raised questions as to the validity of the concept and as to the guidelines developed for its application in practice. The Board has reviewed the concept of residual securities as it relates to earnings per share and, as a result of its own study and the constructive comments on the matter received from interested parties, has concluded that modification of the residual concept is desirable. The Board has also considered the disclosure and presentation requirements of earnings per share data contained in APB Opinion No. 9 and has concluded that these should be revised.

OPINION

Presentation on Face of Income Statement

12. The Board believes that the significance attached by investors and others to earnings per share data, together with the importance of evaluating the data in conjunction with the financial statements, requires that such data be presented prominently in the financial statements. The Board has therefore concluded that earnings per share or net loss per share data should be shown on the face of the income statement. The extent of the data to be presented and the captions used will vary with the complexity of the company's capital structure, as discussed in the following paragraphs.

13. The reporting of earnings per share data should be consistent with the income statement presentation called for by paragraph 20 of APB Opinion No. 9. Earnings per share amounts should therefore be presented for (a) income before extraordinary items and (b) net income. It may also be desir-

able to present earnings per share amounts for extraordinary items, if any.

Simple Capital Structures

14. The capital structures of many corporations are relatively simple—that is, they either consist of only common stock or include no potentially dilutive convertible securities, options, warrants or other rights that upon conversion or exercise could in the aggregate dilute[2] earnings per common share. In these cases, a single presentation expressed in terms such as *Earnings per common share* on the face of the income statement (based on common shares outstanding and computed in accordance with the provisions of paragraphs 47-50 of Appendix A) is the appropriate presentation of earnings per share data.

Complex Capital Structures

15. Corporations with capital structures other than those described in the preceding paragraph should present two types of earnings per share data (dual presentation) with equal prominence on the face of the income statement. The first presentation is based on the outstanding common shares and those securities that are in substance equivalent to common shares and have a dilutive[2] effect. The second is a pro-forma presentation which reflects the dilution[2] of earnings per share that would have occurred if *all* contingent issuances of common stock that would individually reduce earnings per share had taken place at the beginning of the period (or time of issuance of the convertible security, etc., if later). For convenience in this Opinion, these two presentations are referred to as "primary earnings per share" and "fully diluted earnings per share,"[3] respectively, and would in certain circumstances

2 Any reduction of less than 3% in the aggregate need not be considered as dilution in the computation and presentation of earnings per share data as discussed throughout this Opinion. In applying this test only issues which reduce earnings per share should be considered. In establishing this guideline the Board does not imply that a similar measure should be applied in any circumstances other than the computation and presentation of earnings per share data under this Opinion.

3 APB Opinion No. 9 referred to the latter presentation as "supplementary pro forma earnings per share."

discussed elsewhere in this Opinion be supplemented by other disclosures and other earnings per share data. (See paragraphs 19-23.)

Dual Presentation

16. When dual presentation of earnings per share data is required, the primary and fully diluted earnings per share amounts should be presented with equal prominence on the face of the income statement. The difference between the primary and fully diluted earnings per share amounts shows the maximum extent of potential dilution of current earnings which conversions of securities that are not common stock equivalents could create. If the capital structure contains no common stock equivalents, the first may be designated *Earnings per common share—assuming no dilution* and the second *Earnings per common share—assuming full dilution.* When common stock equivalents are present and dilutive, the primary amount may be designated *Earnings per common and common equivalent share.* The Board recognizes that precise designations should not be prescribed; corporations should be free to designate these dual presentations in a manner which best fits the circumstances provided they are in accord with the substance of this Opinion. The term *Earnings per common share* should not be used without appropriate qualification except under the conditions discussed in paragraph 14.

Periods Presented

17. Earnings per share data should be presented for all periods covered by the statement of income or summary of earnings. If potential dilution exists in any of the periods presented, the dual presentation of primary earnings per share and fully diluted earnings per share data should be made for all periods presented. This information together with other disclosures required (see paragraphs 19-23) will give the reader an understanding of the extent and trend of the potential dilution.

18. When results of operations of a prior period included in the statement of income or summary of earnings have been

restated as a result of a prior period adjustment, earnings per share data given for the prior period should be restated. The effect of the restatement, expressed in per share terms, should be disclosed in the year of restatement.

Additional Disclosures

Capital Structure

19. The use of complex securities complicates earnings per share computations and makes additional disclosures necessary. The Board has concluded that financial statements should include a description, in summary form, sufficient to explain the pertinent rights and privileges of the various securities outstanding. Examples of information which should be disclosed are dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking fund requirements, unusual voting rights, etc.

Dual Earnings per Share Data

20. A schedule or note relating to the earnings per share data should explain the bases upon which both primary and fully diluted earnings per share are calculated. This information should include identification of any issues regarded as common stock equivalents in the computation of primary earnings per share and the securities included in the computation of fully diluted earnings per share. It should describe all assumptions and any resulting adjustments used in deriving the earnings per share data.[4] There should also be disclosed the number of shares issued upon conversion, exercise or satisfaction of required conditions, etc., during at least the most recent annual fiscal period and any subsequent interim period presented.[5]

21. Computations and/or reconciliations may sometimes be desirable to provide a clear understanding of the manner in

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4 These computations should give effect to all adjustments which would result from conversion: for example, dividends paid on convertible preferred stocks should not be deducted from net income; interest and related expenses on convertible debt, less applicable income tax, should be added to net income, and any other adjustments affecting net income because of these assumptions should also be made. (See paragraph 51.)

5 See also paragraphs 9 and 10 of APB Opinion No. 12.

which the earnings per share amounts were obtained. This information may include data on each issue of securities entering into the computation of the primary and fully diluted earnings per share. It should not, however, be shown on the face of the income statement or otherwise furnished in a manner implying that an earnings per share amount which ignores the effect of common stock equivalents (that is, earnings per share based on outstanding common shares only) constitutes an acceptable presentation of primary earnings per share.

Supplementary Earnings per Share Data

22. Primary earnings per share should be related to the capital structures existing during each of the various periods presented.[6] Although conversions ordinarily do not alter substantially the amount of capital employed in the business, they can significantly affect the trend in earnings per share data. Therefore, if conversions during the current period would have affected (either dilutively or incrementally) primary earnings per share if they had taken place at the beginning of the period, supplementary information should be furnished (preferably in a note) for the latest period showing what primary earnings per share would have been if such conversions had taken place at the beginning of that period (or date of issuance of the security, if within the period). Similar supplementary per share earnings should be furnished if conversions occur after the close of the period but before completion of the financial report. It may also be desirable to furnish supplementary per share data for each period presented, giving the cumulative retroactive effect of all such conversions or changes. However, primary earnings per share data should not be adjusted retroactively for conversions.

23. Occasionally a sale of common stock or common stock equivalents for cash occurs during the latest period presented or shortly after its close but before completion of the financial report. When a portion or all of the proceeds of such a sale has been used to retire preferred stock or debt, or is to be used for that purpose, supplementary earnings per share data should be

6 See paragraphs 48-49 and 62-64 for exceptions to this general rule.

furnished (preferably in a note) to show what the earnings would have been for the latest fiscal year and any subsequent interim period presented if the retirement had taken place at the beginning of the respective period (or date of issuance of the retired security, if later). The number of shares of common stock whose proceeds are to be used to retire the preferred stock or debt should be included in this computation. The bases of these supplementary computations should be disclosed.[7]

Primary Earnings Per Share

24. If a corporation's capital structure is complex and either does not include common stock equivalents or includes common stock equivalents which do not have a dilutive effect, the primary earnings per share figures should be based on the weighted average number of shares of common stock outstanding during the period. In such cases, potential dilutive effects of contingent issuances would be reflected in the fully diluted earnings per share amounts. Certain securities, however, are considered to be the equivalent of outstanding common stock and should be recognized in the computation of primary earnings per share if they have a dilutive effect.

Nature of Common Stock Equivalents

25. The concept that a security may be the equivalent of common stock has evolved to meet the reporting needs of investors in corporations that have issued certain types of convertible and other complex securities. A common stock equivalent is a security which is not, in form, a common stock but which usually contains provisions to enable its holder to become a common stockholder and which, because of its terms and the circumstances under which it was issued, is in substance equivalent to a common stock. The holders of these securities can expect to participate in the appreciation of the value of the common stock resulting principally from the earnings and earnings potential of the issuing corporation. This participation is essentially the same as that of a common stock-

7 There may be other forms of recapitalization which should be reflected in a similar manner.

holder except that the security may carry a specified dividend or interest rate yielding a return different from that received by a common stockholder. The attractiveness of this type of security to investors is often based principally on this potential right to share in increases in the earnings potential of the issuing corporation rather than on its fixed return or other senior security characteristics. With respect to a convertible security, any difference in yield between it and the underlying common stock as well as any other senior characteristics of the convertible security become secondary. The value of a common stock equivalent is derived in large part from the value of the common stock to which it is related, and changes in its value tend to reflect changes in the value of the common stock. Neither conversion nor the imminence of conversion is necessary to cause a security to be a common stock equivalent.

26. The Board has concluded that outstanding convertible securities which have the foregoing characteristics and which meet the criteria set forth in this Opinion for the determination of common stock equivalents at the time they are issued should be considered the equivalent of common stock in computing primary earnings per share if the effect is dilutive. The recognition of common stock equivalents in the computation of primary earnings per share avoids the misleading implication which would otherwise result from the use of common stock only; use of the latter basis would place form over substance.

27. In addition to convertible debt and convertible preferred stocks, the following types of securities are or may be considered as common stock equivalents:

Stock options and warrants (and their equivalents) and stock purchase contracts—should always be considered common stock equivalents (see paragraphs 35-38).

Participating securities and two-class common stocks—if their participation features enable their holders to share in the earnings potential of the issuing corporation on substantially the same basis as common stock even though the securities may not give the holder the right to exchange his shares for common stock (see paragraphs 59 and 60).

Contingent shares—if shares are to be issued in the future upon the mere passage of time (or are held in escrow pending the satisfaction of conditions unrelated to earnings or market value) they should be considered as outstanding for the computation of earnings per share. If additional shares of stock are issuable for little or no consideration upon the satisfaction of certain conditions they should be considered as outstanding when the conditions are met (see paragraphs 61-64).

Determination of Common Stock Equivalents at Issuance

28. The Board has concluded that determination of whether a convertible security is a common stock equivalent should be made only at the time of issuance and should not be changed thereafter so long as the security remains outstanding. However, convertible securities outstanding or subsequently issued with the same terms as those of a common stock equivalent also should be classified as common stock equivalents. After full consideration of whether a convertible security may change its status as a common stock equivalent subsequent to issuance, including the differing views which are set forth in Appendix B hereto, the Board has concluded that the dilutive effect of any convertible securities that were not common stock equivalents at time of their issuance should be included only in the fully diluted earnings per share amount. This conclusion is based upon the belief (a) that only the conditions which existed at the time of issuance of the convertible security should govern the determination of status as a common stock equivalent, and (b) that the presentation of fully diluted earnings per share data adequately discloses the potential dilution which may exist because of changes in conditions subsequent to time of issuance.

29. Various factors should be considered in determining the appropriate "time of issuance" in evaluating whether a security is substantially equivalent to a common stock. The time of issuance generally is the date when agreement as to terms has been reached and announced, even though subject to certain further actions, such as directors' or stockholders' approval.

No Anti-Dilution

30. Computations of primary earnings per share should not give effect to common stock equivalents or other contingent issuance for any period in which their inclusion would have the effect of increasing the earnings per share amount or decreasing the loss per share amount otherwise computed.[8] Consequently, while a security once determined to be a common stock equivalent retains that status, it may enter into the computation of primary earnings per share in one period and not in another.

Test of Common Stock Equivalent Status

31. *Convertible securities.* A convertible security which at the time of issuance has terms that make it for all practical purposes substantially equivalent to a common stock should be regarded as a common stock equivalent. The complexity of convertible securities makes it impractical to establish definitive guidelines to encompass all the varying terms which might bear on this determination. Consideration has been given, however, to various characteristics of a convertible security which might affect its status as a common stock equivalent, such as cash yield at issuance, increasing or decreasing conversion rates, liquidation and redemption amounts, and the conversion price in relation to the market price of the common stock. In addition, consideration has been given to the pattern of various nonconvertible security yields in recent years, during which period most of the existing convertible securities have been issued, as well as over a longer period of time. Many of the characteristics noted above, which in various degrees may indicate status as a common stock equivalent, are also closely related to the interest or dividend rate of the security and to its market price at the time of issuance.

32. The Board has also studied the use of market price in relation to investment value (value of a convertible security without the conversion option) and market parity (relationship

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8 The presence of a common stock equivalent together with extraordinary items may result in diluting income before extraordinary items on a per share basis while increasing net income per share, or vice versa. If an extraordinary item is present and a common stock equivalent results in dilution of either income before extraordinary items or net income on a per share basis, the common stock equivalent should be recognized for all computations even though it has an anti-dilutive effect on one of the per share amounts.

of conversion value of a convertible security to its market price) as means of determining if a convertible security is equivalent to a common stock. (See discussion of investment value and market parity tests in Appendix B.) It has concluded, however, that these tests are too subjective or not sufficiently practicable.

33. The Board believes that convertible securities should be considered common stock equivalents if the cash yield to the holder at time of issuance is significantly below what would be a comparable rate for a similar security of the issuer without the conversion option. Recognizing that it may frequently be difficult or impossible to ascertain such comparable rates, and in the interest of simplicity and objectivity, the Board has concluded that a convertible security should be considered as a common stock equivalent at the time of issuance if, based on its market price[9], it has a cash yield of less than 66⅔% of the then current bank prime interest rate.[10] For any convertible security which has a change in its cash interest rate or cash dividend rate scheduled within the first five years after issuance, the lowest scheduled rate during such five years should be used in determining the cash yield of the security at issuance.

34. The Board believes that the current bank prime interest rate in general use for short-term loans represents a practical, simple and readily available basis on which to establish the criteria for determining a common stock equivalent, as set forth in the preceding paragraph. The Board recognizes that there are other rates and averages of interest rates relating to various grades of long-term debt securities and preferred stocks which might be appropriate or that a more complex approach could be adopted. However, after giving consideration to various approaches and interest rates in this regard, the Board has concluded that since there is a high degree of correlation between such indices and the bank prime interest rate, the latter is the most practical rate available for this particular purpose.

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[9] If no market price is available, this test should be based on the fair value of the security.

[10] If convertible securities are sold or issued outside the United States, the most comparable interest rate in the foreign country should be used for this test.

35. *Options and warrants (and their equivalents).* Options, warrants and similar arrangements usually have no cash yield and derive their value from their right to obtain common stock at specified prices for an extended period. Therefore, these securities should be regarded as common stock equivalents at all times. Other securities, usually having a low cash yield (see definition of "cash yield", Appendix D), require the payment of cash upon conversion and should be considered the equivalents of warrants for the purposes of this Opinion. Accordingly, they should also be regarded as common stock equivalents at all times. Primary earnings per share should reflect the dilution that would result from exercise or conversion of these securities and use of the funds, if any, obtained. Options and warrants (and their equivalents) should, therefore, be treated as if they had been exercised and earnings per share data should be computed as described in the following paragraphs. The computation of earnings per share should not, however, reflect exercise or conversion of any such security[11] if its effect on earnings per share is anti-dilutive (see paragraph 30) except as indicated in paragraph 38.

36. Except as indicated in this paragraph and in paragraphs 37 and 38, the amount of dilution to be reflected in earnings per share data should be computed by application of the "treasury stock" method. Under this method, earnings per share data are computed as if the options and warrants were exercised at the beginning of the period (or at time of issuance, if later) and as if the funds obtained thereby were used to purchase common stock at the average market price during the period.[12] As a practical matter, the Board recommends that assumption of exercise not be reflected in earnings per share data until the market price of the common stock obtainable has been in excess of the exercise price for substantially all of three consecutive months ending with the last month of the

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11 Reasonable grouping of like securities may be appropriate.

12 For example, if a corporation has 10,000 warrants outstanding, exercisable at $54 and the average market price of the common stock during the reporting period is $60, the $540,000 which would be realized from exercise of the warrants and issuance of 10,000 shares would be an amount sufficient to acquire 9,000 shares; thus 1,000 shares would be added to the outstanding common shares in computing primary earnings per share for the period.

period to which earnings per share data relate. Under the treasury stock method, options and warrants have a dilutive effect (and are, therefore, reflected in earnings per share computations) only when the average market price of the common stock obtainable upon exercise during the period exceeds the exercise price of the options or warrants. Previously reported earnings per share amounts should not be retroactively adjusted, in the case of options and warrants, as a result of changes in market prices of common 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 earnings per share computations is not based on an assumption that the funds will or could actually be used in that manner. In the usual case, it 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. The Board has concluded, however, that the treasury stock method is inappropriate, or should be modified, in certain cases described in paragraphs 37 and 38.

37. Some warrants contain provisions which permit, or require, the tendering of debt (usually at face amount) or other securities of the issuer in payment for all or a portion of the exercise price. The terms of some debt securities issued with warrants require that the proceeds of the exercise of the related warrants be applied toward retirement of the debt. As indicated in paragraph 35, some convertible securities require cash payments upon conversion and are, therefore, considered to be the equivalent of warrants. In all of these cases, the "if converted" method (see paragraph 51) should be applied as if retirement or conversion of the securities had occurred and as if the excess proceeds, if any, had been applied to the purchase of common stock under the treasury stock method. However, exercise of the options and warrants should not be reflected in the computation unless for the period specified in paragraph 36 either (a) the market price of the related common stock exceeds the exercise price or (b) the security which may be (or

must 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 that can be obtained upon exercise. Similar treatment should be followed for preferred stock bearing similar provisions or other securities having conversion options permitting payment of cash for a more favorable conversion rate from the standpoint of the investor.

38. The treasury stock method of reflecting use of proceeds from options and warrants may not adequately reflect potential dilution when options or warrants to acquire a substantial number of common shares are outstanding. Accordingly, the Board has concluded that, if the number of shares of common stock obtainable upon exercise of outstanding options and warrants in the aggregate exceeds 20% of the number of common shares outstanding at the end of the period for which the computation is being made, the treasury stock method should be modified in determining the dilutive effect of the options and warrants upon earnings per share data. In these circumstances all the options and warrants should be assumed to have been exercised and the aggregate proceeds therefrom to have been applied in two steps:

a. As if the funds obtained were first applied to the repurchase of outstanding common shares at the average market price during the period (treasury stock method) but not to exceed 20% of the outstanding shares; and then

b. As if the balance of the funds were applied first to reduce any short-term or long-term borrowings and any remaining funds were invested in U.S. government securities or commercial paper, with appropriate recognition of any income tax effect.

The results of steps (a) and (b) of the computation (whether dilutive or anti-dilutive) should be aggregated and, if the net effect is dilutive, should enter into the earnings per share computation.[13]

Non-Recognition of Common Stock Equivalents in Financial Statements

39. The designation of securities as common stock equivalents in this Opinion is solely for the purpose of determining primary earnings per share. No changes from present practices are recommended in the accounting for such securities, in their presentation within the financial statements or in the manner of determining net assets per common share. Information is available in the financial statements and elsewhere for readers to make judgments as to the present and potential status of the various securities outstanding.

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[13] The following are examples of the application of Paragraph 38:

	Case 1	Case 2
Assumptions:		
Net income for year	$ 4,000,000	$ 2,000,000
Common shares outstanding	3,000,000	3,000,000
Options and warrants outstanding to purchase equivalent shares	1,000,000	1,000,000
20% limitation on assumed repurchase	600,000	600,000
Exercise price per share	$15	$15
Average and year-end market value per common share to be used (see paragraph 42)	$20	$12
Computations:		
Application of assumed proceeds ($15,000,000):		
Toward repurchase of outstanding common shares at applicable market value	$12,000,000	$ 7,200,000
Reduction of debt	3,000,000	7,800,000
	$15,000,000	$15,000,000
Adjustment of net income:		
Actual net income	$ 4,000,000	$ 2,000,000
Interest reduction (6%) less 50% tax effect	90,000	234,000
Adjusted net income (A)	$ 4,090,000	$ 2,234,000
Adjustment of shares outstanding:		
Actual outstanding	3,000,000	3,000,000
Net additional shares issuable (1,000,000 − 600,000)	400,000	400,000
Adjusted shares outstanding (B)	3,400,000	3,400,000
Earnings per share:		
Before adjustment	$1.33	$ .67
After adjustment (A ÷ B)	$1.20	$ .66

Fully Diluted Earnings Per Share

No Anti-Dilution

40. The purpose of the fully diluted earnings per share presentation is to show the maximum potential dilution of current earnings per share on a prospective basis. Consequently, computations of fully diluted earnings per share for each period should exclude those securities whose conversion, exercise or other contingent issuance would have the effect of increasing the earnings per share amount or decreasing the loss per share amount[14] for such period.

When Required

41. Fully diluted earnings per share data should be presented on the face of the statement of income for each period presented if shares of common stock (a) were issued during the period on conversions, exercise, etc., or (b) were contingently issuable at the close of any period presented and if primary earnings per share for such period would have been affected (either dilutively or incrementally) had such actual issuances taken place at the beginning of the period or would have been reduced had such contingent issuances taken place at the beginning of the period. The above contingencies may result from the existence of (a) senior stock or debt which is convertible into common shares but is not a common stock equivalent, (b) options or warrants, or (c) agreements for the issuance of common shares upon the satisfaction of certain conditions (for example, the attainment of specified higher levels of earnings following a business combination). The computation should be based on the assumption that all such issued and issuable shares were outstanding from the beginning of the period (or from the time the contingency arose, if after the beginning of the period). Previously reported fully diluted earnings per share amounts should not be retroactively adjusted for subsequent conversions or subsequent changes in the market prices of the common stock.

42. The methods described in paragraphs 36-38 should be used to compute fully diluted earnings per share if dilution results from outstanding options and warrants; however, in

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[14] See footnote 8.

order to reflect maximum potential dilution, the market price at the close of the period reported upon should be used to determine the number of shares which would be assumed to be repurchased (under the treasury stock method) if such market price is higher than the average price used in computing primary earnings per share (see paragraph 30). Common shares issued on exercise of options or warrants during each period should be included in fully diluted earnings per share from the beginning of the period or date of issuance of the options or warrants if later; the computation for the portion of the period prior to the date of exercise should be based on market prices of the common stock when exercised.

Situations Not Covered in Opinion

43. The Board recognizes that it is impracticable to cover all possible conditions and circumstances that may be encountered in computing earnings per share. When situations not expressly covered in this Opinion occur, however, they should be dealt with in accordance with their substance, giving cognizance to the guidelines and criteria outlined herein.

Computational Guidelines

44. The determination of earnings per share data required under this Opinion reflects the complexities of the capital structures of some businesses. The calculations should give effect to matters such as stock dividends and splits, business combinations, changes in conversion rates, etc. Guidelines which should be used in dealing with some of the more common computational matters are set forth in Appendix A hereto.

EFFECTIVE DATE

45. This Opinion shall be effective for fiscal periods beginning after December 31, 1968 for all earnings per share data (primary, fully diluted and supplementary) regardless of when the securities entering into computations of earnings per share were issued, except as described in paragraph 46 as it relates to primary earnings per share. The Board recommends that (a) computations for periods beginning before January 1, 1969 be made for all securities in conformity with the provisions of this Opinion and (b) in comparative statements in which the data for some periods are subject to this Opinion and others are not,

the provisions of the Opinion be applied to all periods—in either case based on the conditions existing in the prior periods.

46. In the case of securities whose time of issuance is prior to June 1, 1969 the following election should be made as of May 31, 1969 (and not subsequently changed) with respect to all such securities for the purpose of computing primary earnings per share:

a. determine the classifications of all such securities under the provisions of this Opinion, or
b. classify as common stock equivalents only those securities which are classified as residual securities under APB Opinion No. 9 regardless of how they would be classified under this Opinion.

If the former election is made, the provisions of this Opinion should be applied in the computation of both primary and fully diluted earnings per share data for all periods presented.

The Opinion entitled "Earnings per Share" was adopted by the assenting votes of fifteen members of the Board, of whom five, Messrs. Axelson, Davidson, Harrington, Hellerson and Watt, assented with qualification. Messrs. Halvorson, Seidman and Weston dissented.

Messrs. Axelson and Watt dissent to the requirement in paragraphs 35 and 36 that options and warrants whose exercise price is at or above the market price of related common stock at time of issuance be taken into account in the computation of *primary* earnings per share. They believe that this destroys the usefulness of the dual presentation of primary and fully diluted earnings per share by failing to disclose the magnitude of the contingency arising from the outstanding warrants and options and is inconsistent with the determination of the status of convertible securities at time of issuance only. Therefore, they concur with the comments in paragraph 86. They also dissent to the 20 percent limitation in paragraph 38 on use of the treasury stock method of applying proceeds from the assumed exercise of options and warrants because such limitation is arbitrary and unsupported and because of the inconsistency between this limitation and the Board's conclusion expressed in paragraph 36 that use of the treasury stock method "is not based on an assumption that the funds will or could actually be used in that manner." Further, they dissent to the requirement in paragraphs 63 and 64 that the computation of *primary* earnings per share take into account shares of stock issuable in connection with business combinations on a purely contingent basis, wholly dependent upon the movement of market prices in the future.

Mr. Davidson assents to the issuance of this Opinion because he believes that practice under Part II of APB Opinion No. 9 has been so varied that clarification of APB Opinion No. 9 is necessary. He agrees with the concept of common stock equivalents, but dissents to the conclusion that convertible securities can be classified as common stock equivalents only by consideration of conditions prevailing at the time of their issuance (paragraph 28). He believes that in determining common stock equivalency, current conditions reflected in the market place are the significant criterion (paragraphs 74-77). The use of the investment value method (paragraphs 79-81) adequately reflects these current conditions.

Mr. Davidson also dissents to the use of the bank prime rate for the cash-yield test (paragraphs 33-34). It does not differentiate among types of securities issued nor the standing of the issuers.

Mr. Harrington assents to the issuance of the Opinion; however, he dissents from paragraphs 36, 37 and 38. He believes it is inconsistent in computing fully diluted earnings per share to measure potential dilution by the treasury stock method in the case of most warrants and to assume conversion in the case of convertible securities. This inconsistency, in his view, results in required recognition of potential dilution attributable to all convertible securities; and, at the same time through the use of the treasury stock method, permits understatement or no recognition of potential dilution attributable to warrants. He further believes that the potential dilution inherent in warrants should be recognized in fully diluted earning per share, but need not be recognized in primary earnings per share, when the exercise price exceeds the market price of the stock.

Mr. Hellerson assents to the issuance of this Opinion because he believes the Board has an obligation to resolve without further delay the implementation problems raised by Part II of APB Opinion No. 9 which have been greatly extended by the characteristics of a number of the securities issued since the release of that Opinion. However, he dissents from the mandatory requirement that earnings per share be shown on the face of the income statement as prescribed in paragraphs 12 through 16 and paragraph 41. The accounting profession has taken the position, and in his view rightly so, that fair presentation of financial position and results of operations requires the presentation of certain basic financial statements supplemented by disclosure of additional information in the form of separate statements or notes to the basic financial statements. Fair presentation is achieved by the whole presentation, not by the specific location of any item. This principle was most recently restated by the Board in paragraph 10 of APB Opinion No. 12 on capital changes as follows: "Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto." Accordingly, it is his view that, although the Opinion should require dual presentation of earnings per share, it should not specify that the presentation must be made on the face of the income statement and thereby dignify one figure above all others.

Mr. Halvorson dissents to the Opinion because he believes the subject matter is one of financial analysis, not accounting principles, and that any expression by the Accounting Principles Board on the subject should not go beyond requiring such disclosure of the respective rights and priorities of the several issues of securities which may be represented in the capital structure of a reporting corporation as will permit an investor to make his own analysis of the effects of such rights and priorities on earnings per common share. Mr. Halvorson agrees that certain nominally senior securities are the equivalent of common shares under certain circumstances, but believes that the determination of common-stock equivalence is a subjective one which cannot be accommodated within prescribed formulae or arithmetical rules, although it can be facilitated by disclosure of information which does fall within the bounds of fair presentation in conformity with generally accepted accounting principles. Mr. Halvorson believes that a corporation should not be denied the right to report factually determined earnings per weighted average outstanding common share on the face of the income statement as a basis against which to measure the potential dilutive effects on earnings per share of senior issues, and that from such basis the investor may make such pro forma calculations of common-stock equivalence as he believes best serve his purpose.

Mr. Seidman dissents for the reasons set forth in paragraphs 72, 73, 92 and 93, dealing with the invalidity and inconsistent application of the concept of common stock equivalents. He adds: (1) It is unsound for the determination of earnings per share to depend on the fluctuations of security prices. It is even more unsound when an increase in security prices can result in a decrease in earnings per share, and vice versa. These matters arise under this Opinion since it calls for earnings per share based on cash yield of convertibles, comparison of stock and exercise prices of options and warrants, and no anti-dilution. (2) It is erroneous to attribute earnings to securities that do not currently and may never share in those earnings, particularly when part or all of those earnings may have already been distributed to others as dividends. (3) It does not serve the interests of meaningful disclosure when, as in paragraph 21, the Opinion bans showing on the face of the income statement any reference to the amount of earnings per share in relation to the one factual base, namely the number of shares actually outstanding, and instead fashions from various surmises what it calls "primary earnings per share". (4) It is baffling to say, as does this Opinion, that convertible debt is debt in the statement of earnings but is common stock equivalent in the statement of earnings per share; and that dividends per share are based on the actual number of shares outstanding, while earnings per share are based on a different and larger number of shares.

Mr. Weston dissents to the issuance of this Opinion because he believes it represents a significant retrogression in terms of the purpose of the Accounting Principles Board. The residual security concept, which has been successfully and appropriately applied to convertible securities during the period since issuance of APB Opinion No. 9, has, in this Opinion, been so restricted as to be meaningless for all practical purposes with respect to such securities. Accordingly, computations of primary earnings per share data under the provisions of this Opinion (paragraph 28 in particular) will not properly reflect the characteristics of those convertible securities which are currently the substantial equivalent of common stock—and are so recognized in the marketplace—which did not qualify for residual status at their date of issuance—possibly years previously. Such disregard of basic principles is a disservice to investors, who have a right to view the primary earnings per share data computed under this Opinion as a realistic attribution of the earnings of the issuer to the various complex elements of its capital structure based on the economic realities of today—not those existing years ago.

Mr. Weston also disagrees with the conclusions contained in paragraphs 33, 36, 39 and 51.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October, 1964) provides that:*

a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or *in independent auditors' reports when the effect of the departure on the financial statements is material.*

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

APPENDIX A
COMPUTATIONAL GUIDELINES

CONTENTS

APPENDIX A
COMPUTATIONAL GUIDELINES

The Board has adopted the following general guidelines which should be used in the computation of earnings per share data.

47. *Weighted average.* Computations of earnings per share data should be based on the weighted average number of common shares and common share equivalents outstanding during each period presented. Use of a weighted average is necessary so that the effect of increases or decreases in outstanding shares on earnings per share data is related to the portion of the period during which the related consideration affected operations. Reacquired shares should be excluded from date of their acquisition. (See definition in Appendix D.)

48. *Stock dividends or splits.* If the number of common shares outstanding increases as a result of a stock dividend or stock split[15] or decreases as a result of a reverse split, the computations should give retroactive recognition to an appropriate equivalent change in capital structure for all periods presented. If changes in common stock resulting from stock dividends or stock splits or reverse splits have been consummated after the close of the period but before completion of the financial report, the per share computations should be based on the new number of shares because the readers' primary interest is presumed to be related to the current capitalization. When per share computations reflect such changes in the number of shares after the close of the period, this fact should be disclosed.

49. *Business combinations and reorganizations.* When shares are issued to acquire a business in a transaction accounted for as a purchase, the computation of earnings per share should give recognition to the existence of the new shares only from the date the acquisition took place. When a business combination is accounted for as a pooling of interests, the computation should be based on the aggregate of the

[15] See ARB No. 43, Chapter 7B, *Capital Accounts—Stock Dividends and Stock Split Ups.*

weighted average outstanding shares of the constituent businesses, adjusted to equivalent shares of the surviving business for all periods presented. This difference in treatment reflects the fact that in a purchase the results of operations of the acquired business are included in the statement of income only from the date of acquisition, whereas in a pooling of interests the results of operations are combined for all periods presented. In reorganizations, the computations should be based on analysis of the particular transaction according to the criteria contained in this Opinion.

50. *Claims of senior securities.* The claims of senior securities on earnings of a period should be deducted from net income (and also from income before extraordinary items if an amount therefor appears in the statement) before computing earnings per share. Dividends on cumulative preferred senior securities, whether or not earned, should be deducted from net income.[16] If there is a net loss, the amount of the loss should be increased by any cumulative dividends for the period on these preferred stocks. If interest or preferred dividends are cumulative only if earned, no adjustment of this type is required, except to the extent of income available therefor. If interest or preferred dividends are not cumulative, only the interest accruable or dividends declared should be deducted. In all cases, the effect that has been given to rights of senior securities in arriving at the earnings per share should be disclosed.

51. *Use of "if converted" method of computation.* If convertible securities are deemed to be common stock equivalents for the purpose of computing primary earnings per share, or are assumed to have been converted for the purpose of computing fully diluted earnings per share, the securities should be assumed to have been converted at the beginning of the earliest period reported (or at time of issuance, if later). Interest charges applicable to convertible securities and non-discretionary adjustments that would have been made to items based on net income or income before taxes—such as profit sharing ex-

16 The per share and aggregate amounts of cumulative preferred dividends in arrears should be disclosed.

pense, certain royalties, and investment credit—or preferred dividends applicable to the convertible securities should be taken into account in determining the balance of income applicable to common stock. As to primary earnings per share this amount should be divided by the total of the average outstanding common shares and the number of shares which would have been issued on conversion or exercise of common stock equivalents.[17] As to fully diluted earnings per share this amount should be divided by the total of the average outstanding common shares plus the number of shares applicable to conversions during the period from the beginning of the period to the date of conversion and the number of shares which would have been issued upon conversion or exercise of any other security which might dilute earnings.

52. The if converted method recognizes the fact that the holders of convertible securities cannot share in distributions of earnings applicable to the common stock unless they relinquish their right to senior distributions. Conversion is assumed and earnings applicable to common stock and common stock equivalents are determined before distributions to holders of these securities.

53. The if converted method also recognizes the fact that a convertible issue can participate in earnings, through dividends or interest, either as a senior security or as a common stock, but not both. The two-class method (see paragraph 55) does not recognize this limitation and may attribute to common stock an amount of earnings per share less than if the convertible security had actually been converted. The amount of earnings per share on common stock as computed under the two-class method is affected by the amount of dividends declared on the common stock.

54. *Use of "two-class" method of computation.* Although the two-class method is considered inappropriate with respect to the securities described in paragraph 51, its use may be necessary in the case of participating securities and two-class common stock. (See paragraphs 59-60 for discussion of these

[17] Determined as to options and warrants by application of the method described in paragraphs 36-38 of this Opinion.

securities.) This is the case, for example, when these securities are not convertible into common stock.

55. Under the two-class method, common stock equivalents are treated as common stock with a dividend rate different from the dividend rate on the common stock and, therefore, conversion of convertible securities is not assumed. No use of proceeds is assumed. Distributions to holders of senior securities, common stock equivalents and common stock are first deducted from net income. The remaining amount (the undistributed earnings) is divided by the total of common shares and common share equivalents. Per share distributions to the common stockholders are added to this per share amount to arrive at primary earnings per share.

56. *Delayed effectiveness and changing conversion rates or exercise prices.* In some cases, a conversion option does not become effective until a future date; in others conversion becomes more (or less) advantageous to the security holder at some later date as the conversion rate increases (or decreases), generally over an extended period. For example, an issue may be convertible into one share of common stock in the first year, 1.10 shares in the second year, 1.20 shares in the third year, etc. Frequently, these securities receive little or no cash dividends. Hence, under these circumstances, their value is derived principally from their conversion or exercise option and they would be deemed to be common stock equivalents under the yield test previously described. (See paragraph 33 of this Opinion.)[18] Similarly, the right to exercise options or warrants may be deferred or the exercise price may increase or decrease.

57. *Conversion rate or exercise price to be used — primary earnings per share.* The conversion rate or exercise price of a common stock equivalent in effect during each period presented should be used in computing primary earnings per share, with the exceptions stated hereinafter in this paragraph. Prior period primary earnings per share should not be restated for changes in the conversion ratio or exercise price. If options, warrants or other common stock equivalents are not immedi-

[18] An increasing conversion rate should not be accounted for as a stock dividend.

ately exercisable or convertible, the earliest effective exercise price or conversion rate if any during the succeeding five years should be used. If a convertible security having an increasing conversion rate is issued in exchange for another class of security of the issuing company and is convertible back into the same or a similar security, and if a conversion rate equal to or greater than the original exchange rate becomes effective during the period of convertibility, the conversion rate used in the computation should not result in a reduction in the number of common shares (or common share equivalents) existing before the original exchange took place until a greater rate becomes effective.

58. *Conversion rate or exercise price to be used — fully diluted earnings per share.* Fully diluted earnings per share computations should be based on the most advantageous (from the standpoint of the security holder) conversion or exercise rights that become effective within ten years following the closing date of the period being reported upon.[19] Conversion or exercise options that are not effective until after ten or more years may be expected to be of limited significance because (a) investors' decisions are not likely to be influenced substantially by events beyond ten years, and (b) it is questionable whether they are relevant to current operating results.

59. *Participating securities and two-class common.* The capital structures of some companies include:

a. Securities which 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 or voting rights from those of another class of common stock, but without prior or senior rights.

Additionally, some of these securities are convertible into

[19] The conversion rate should also reflect the cumulative effect of any stock dividends on the preferred stock which the company has contracted or otherwise committed itself to issue within the next ten years.

common stock. Earnings per share computations relating to certain types of participating securities may require the use of the two-class method. (See paragraphs 54-55.)

60. Because of the variety of features which these securities possess, frequently representing combinations of the features referred to above, it is not practicable to set out specific guidelines as to when they should be considered common stock equivalents. Dividend participation does not *per se* make a security a common stock equivalent. A determination of the status of one of these securities should be based on an analysis of all the characteristics of the security, including the ability to share in the earnings potential of the issuing corporation on substantially the same basis as the common stock.

61. *Issuance contingent on certain conditions.* At times, agreements call for the issuance of additional shares contingent upon certain conditions being met. Frequently these conditions are either:

a. the maintenance of current earnings levels, or

b. the attainment of specified increased earnings.

Alternatively, agreements sometimes provide for immediate issuance of the maximum number of shares issuable in the transaction with some to be placed in escrow and later returned to the issuer if specified conditions are not met. For purposes of computing earnings per share, contingently returnable shares placed in escrow should be treated in the same manner as contingently issuable shares.

62. If attainment or maintenance of a level of earnings is the condition, and if that level is currently being attained, the additional shares should be considered as outstanding for the purpose of computing both primary and fully diluted earnings per share. If attainment of increased earnings reasonably above the present level or maintenance of increased earnings above the present level over a period of years is the condition, the additional shares should be considered as outstanding only for the purpose of computing fully diluted earnings per share (but only if dilution is the result); for this computation, earnings

should be adjusted to give effect to the increase in earnings specified by the particular agreements (if different levels of earnings are specified, the level that would result in the largest potential dilution should be used). Previously reported earnings per share data should not be restated to give retroactive effect to shares subsequently issued as a result of attainment of specified increased earnings levels. If upon expiration of the term of the agreement providing for contingent issuance of additional shares the conditions have not been met, the shares should not be considered outstanding in that year. Previously reported earnings per share data should then be restated to give retroactive effect to the removal of the contingency.

63. The number of shares contingently issuable may depend on the market price of the stock at a future date. In such a case, computations of earnings per share should reflect the number of shares which would be issuable based on the market price at the close of the period being reported on. Prior period earnings per share should be restated if the number of shares issued or contingently issuable subsequently changes because the market price changes.

64. 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 number of shares which would be issuable should be based on both conditions, that is, market prices and earnings to date as they exist at the end of each period being reported on. (For example, if (a) a certain number of shares will be issued at the end of three years following an acquisition if earnings of the acquired company increase during those three years by a specified amount and (b) a stipulated number of additional shares will be issued if the value of the shares issued in the acquisition is not at least a designated amount at the end of the three-year period, the number of shares to be included in the earnings per share for each period should be determined by reference to the cumulative earnings of the acquired company and the value of the shares at the end of the latest period.) Prior-period earnings per share should be restated if the number of shares issued or contingently issuable subsequently changes from the number of

shares previously included in the earnings per share computation.

65. *Securities of subsidiaries.* At times subsidiaries issue securities which should be considered common stock equivalents from the standpoint of consolidated and parent company financial statements for the purpose of computing earnings per share. This could occur when convertible securities, options, warrants or common stock issued by the subsidiary are in the hands of the public and the subsidiary's results of operations are either consolidated or reflected on the equity method. Circumstances in which conversion or exercise of a subsidiary's securities should be assumed for the purpose of computing the consolidated and parent company earnings per share, or which would otherwise require recognition in the computation of earnings per share data, include those where:

As to the Subsidiary

a. Certain of the subsidiary's securities are common stock equivalents in relation to its own common stock.
b. Other of the subsidiary's convertible securities, although not common stock equivalents in relation to its own common stock, would enter into the computation of its fully diluted earnings per share.

As to the Parent

a. The subsidiary's securities are convertible into the parent company's common stock.
b. The subsidiary issues options and warrants to purchase the parent company's common stock.

The treatment of these securities for the purpose of consolidated and parent company reporting of earnings per share is discussed in the following four paragraphs.

66. If a subsidiary has dilutive warrants or options outstanding or dilutive convertible securities which are common stock equivalents from the standpoint of the subsidiary, consolidated and parent company primary earnings per share should include the portion of the subsidiary's income that would be applicable to the consolidated group based on its

holdings and the subsidiary's primary earnings per share. (See paragraph 39 of this Opinion.)

67. If a subsidiary's convertible securities are not common stock equivalents from the standpoint of the subsidiary, only the portion of the subsidiary's income that would be applicable to the consolidated group based on its holdings and the fully diluted earnings per share of the subsidiary should be included in consolidated and parent company fully diluted earnings per share. (See paragraph 40 of this Opinion.)

68. If a subsidiary's securities are convertible into its parent company's stock, they should be considered among the common stock equivalents of the parent company for the purpose of computing consolidated and parent company primary and fully diluted earnings per share if the conditions set forth in paragraph 33 of this Opinion exist. If these conditions do not exist, the subsidiary's convertible securities should be included in the computation of the consolidated and parent company fully diluted earnings per share only.

69. If a subsidiary issues options or warrants to purchase stock of the parent company, they should be considered common stock equivalents by the parent in computing consolidated and parent company primary and fully diluted earnings per share.

70. *Dividends per share.* Dividends constitute historical facts and usually are so reported. However, in certain cases, such as those affected by stock dividends or splits or reverse splits, the presentation of dividends per share should be made in terms of the current equivalent of the number of common shares outstanding at the time of the dividend. A disclosure problem exists in presenting data as to dividends per share following a pooling of interests. In such cases, it is usually preferable to disclose the dividends declared per share by the principal constituent and to disclose, in addition, either the amount per equivalent share or the total amount for each period for the other constituent, with appropriate explanation of the circumstances. When dividends per share are presented on other than an historical basis, the basis of presentation should be disclosed.

APPENDIX B

SUMMARY OF DIFFERING VIEWPOINTS

CONTENTS

Paragraph Numbers

APPENDIX B

SUMMARY OF DIFFERING VIEWPOINTS

This Appendix contains a summary of various viewpoints on a number of matters relating to the computation of earnings per share data, which viewpoints differ from the conclusions of the Board as stated in this Opinion. The views in this Appendix therefore do not represent the views of the Board as a whole.

Common Stock Equivalent or Residual Concept

71. This Opinion concludes (paragraph 26) that, for purposes of computing primary earnings per share, certain securities should be considered the equivalent of common stock. The Opinion further concludes (paragraph 28) that such treatment — as to convertible securities — should be based on a determination of status made at the time of issuance of each security, based on conditions existing at that date and not subsequently changed. Viewpoints which differ from those conclusions are based on a number of positions, which are summarized below.

Concept Has No Validity

72. Some believe there should be no such category as "common stock equivalent" or "residual" security, and hence no such classification as "primary" earnings per share including such securities. They contend that the common stock equivalent or residual security concept involves assumptions and arbitrary, intricate determinations which result in figures of questionable meaning which are more likely to confuse than enlighten readers. They advocate that earnings per share data be presented in a tabulation — as part of the financial statements — which first discloses the relationship of net income and the number of common shares actually outstanding and then moves through adjustments to determine adjusted net income and the number of common shares which would be outstanding if all conversions, exercises and contingent issuances took place. Under this approach, all the figures involved would be

readily determinable, understandable and significant. Such information, together with the other disclosures required in this Opinion regarding the terms of securities, would place the reader in a position to make his own judgment regarding prospects of conversion or exercise and the resulting impact on per share earnings. Accounting should not make or pre-empt that judgment.

73. Until convertible securities, etc., are in fact converted, the actual common stockholders are in control, and the entire earnings could often be distributed as dividends. The conversions, exercises and contingent issuances may, in fact, never take place. Hence, the reporting as "primary" earnings per share of an amount which results from treating as common stock securities which are not common stock is, in the view of some, improper.

Concept Has Validity Both At Issuance and Subsequently

74. Some who believe in the validity of the common stock equivalent or residual concept feel that the status of a security should be determined not only at the time of its issuance but from time to time thereafter. Securities having the characteristics associated with residual securities – among other things the ability to participate in the economic benefits resulting from the underlying earnings and earnings potential of the common stock through the right of their holders to become common stockholders – do change their nature with increases and decreases in the market value of the common stock after issuance. These securities are designed for this purpose, and therefore, in certain circumstances, they react to changes in the earnings or earnings potential of the issuer just as does the common stock. Furthermore, although many such securities are issued under market and yield conditions which do not place major emphasis at the time of issuance on their common stock characteristics, both the issuer and the holder recognize the possibility that these characteristics may become of increasing significance if, and when, the value of the underlying common stock increases. The limitation of the residual concept for convertible securities to "at issuance only" disregards these

significant factors. (For example, a convertible security with a cash yield of 4% at time of issuance [assumed to be in excess of the yield test for common stock equivalent status in this Opinion] may well appreciate in value subsequent to issuance, due to its common stock characteristics, to such an extent that its cash yield will drop to 2% or less. It seems unsound to consider such a security a "senior security" for earnings per share purposes at such later dates merely because its yield at date of issuance – possibly years previously – was 4%. This seems particularly unwise when the investment community evaluates such a security currently as the substantial equivalent of the common stock into which it is convertible.) Thus, the "at issuance only" application of the residual security concept is, in the opinion of some, illogical and arbitrary. In connection with the computation of earnings per share data, this approach disregards current conditions in reporting a financial statistic whose very purpose is a reflection of the *current* substantive relationship between the earnings of the issuer and its complex capital structure.

75. Furthermore, the adoption of the treasury stock method to determine the number of shares to be considered as common stock equivalents under outstanding options and warrants (see paragraphs 36-38) is apparent recognition of the fact that market conditions subsequent to issuance should influence the determination of the status of a security. Thus, the conclusions of the Opinion in these matters are inconsistent.

76. As for the contention that use of the residual concept subsequent to issuance has a "circular" effect – in that reported earnings per share influences the market, which, in turn, influences the classification status of a security, which, in turn, influences the computation of earnings per share, which, in turn, influences the market – analysts give appropriate recognition to the increasing importance of the common stock characteristics of convertible securities as the market rises or falls. It seems only appropriate that a computation purporting to attribute the earnings of a corporation to the various components of its capital structure should also give adequate recognition to the changing substance of these securities. Thus, the

movement of securities in and out of residual status subsequent to their issuance is a logical and integral part of the entire concept.

77. As for the contention that the dual presentation of earnings per share data required by this Opinion appropriately reflects the dilutive effect of any convertible securities which were not residual at time of issuance but which might subsequently be considered as residual, the disclosure of "fully-diluted" earnings per share data is aimed at *potential* (i.e., possible future) dilution; for issuers with securities having extremely low yields of the levels described in the preceding paragraph, the dilution has already taken place — these common stock equivalents are being so traded in the market, and any method which does not reflect these conditions results in an amount for "primary earnings per share" which may be misleading. Furthermore, whenever an issuer has more than one convertible security outstanding, the effect of even the "potential" dilution of such "residual" securities is not appropriately reflected in any meaningful manner in the fully-diluted earnings per share amount, since its impact is combined with that of other convertible securities of the issuer which may not currently be "residual".

Criteria and Methods for Determination of Residual Status

78. This Opinion concludes (paragraph 33) that a cash yield test — based on a specified percentage of the bank prime interest rate — should be used to determine the residual status of convertible securities, and that options and warrants should be considered residual securities at all times. Viewpoints differing from those conclusions and supporting other criteria or methods are summarized below.

Convertible Securities

79. *Investment value method.* As explained in paragraphs 8-11 of this Opinion, a previous Opinion specified a relative value method for the determination of the residual status of a security. In practice the method has been applied by comparing the market value of a convertible security with its "invest-

ment value", and by classifying a security as residual at time of issuance if such market value were 200% or more of investment value, with certain practical modifications of this test subsequent to time of issuance to assure the substance of an apparent change in status and to prevent frequent changes of status for possible temporary fluctuations in the market.

80. The establishment of investment values for convertible securities involves considerable estimation, and frequently requires the use of experts. Published financial services report estimates of investment value for many, but not all, convertible securities. Most convertible securities are issued under conditions which permit a reasonable estimate of their investment values. In addition, reference to the movements of long-term borrowing rates for groups of issuers with similar credit and risk circumstances – or even reference to general long-term borrowing rates – can furnish effective evidence for an appropriate determination of the investment value of a convertible security subsequent to its issuance. As in many determinations made for accounting purposes, estimates of this nature are often necessary. The necessity of establishing some percentage or level as the line of demarcation between residual and nonresidual status is common to all methods under consideration – including the market parity test and various yield tests – and appears justifiable in the interest of reasonable consistency of treatment, both for a single issuer and among issuers.

81. The investment value method is somewhat similar to the cash yield method specified in paragraph 33 of this Opinion. However, the latter method has two apparent weaknesses, in the view of those who support the investment value method. In the first place, it does not differentiate between issuers – that is, it is based on the same borrowing rate for all issuers, without regard for their credit ratings or other risks inherent in their activities. Second, it is based on the current bank prime interest rate, which is essentially a short-term borrowing rate. The relationship between this rate – assuming that it is constant in all sections of the country at any given time – and the long-term corporate borrowing rate may fluctuate to such an extent that the claimed ease of determination may be offset by

a lack of correlation. The investment value method, based on the terms of each issue and the status of each issuer, is thus considered by some to be a more satisfactory method.

82. *Market parity method.* This method compares a convertible security's market value with its conversion value. In general, if the two values are substantially equivalent and in excess of redemption price, the convertible security is considered to be "residual".

83. The market parity method has the advantage, as compared to the investment value method, of using amounts that usually are readily available or ascertainable, and of avoiding estimates of investment value. More importantly, in the view of some, the equivalence of values is clearly an indication of the equivalence of the securities, while a comparison of relative values of the characteristics of a security is an indication of its status only if arbitrary rules, such as the "major portion of value" test, are used. In similar vein, the yield test also requires the establishment of a point at which to determine residuality. On the other hand, a practical application of the market parity test would also require the establishment of a percentage relationship at which to determine residual status, due to the many variables involved and the need for consistent application. Also, the call or redemption price of a convertible security has an effect on the point at which market parity is achieved.

84. *Yield methods.* There are various other methods of determining the residual nature of a convertible security based on yield relationships. Each of these is based on a comparison of the cash yield on the convertible security (based on its market value) and some predetermined rate of yield (based on other values, conditions or ratings). The discussion of the various methods contained in this Opinion comprehends the advantages and disadvantages of these other methods.

Options and Warrants

85. As explained in paragraphs 35-38 of this Opinion, options and warrants should be regarded as common stock equivalents

at all times; the "treasury stock method" should be used in most cases to determine the number of common shares to be considered the equivalent of the options and warrants; and the number of common shares so computed should be included in the computation of both the "primary" and "fully-diluted" earnings per share (assuming a dilutive effect). Viewpoints which differ from those conclusions and support other treatments or other methods of measurement are summarized below.

86. *Exclusion from computation of primary earnings per share.* In this Opinion the Board has for the first time considered options and warrants to be common stock equivalents at all times and, because of the treasury stock method of computation established, the primary earnings per share will in some cases be affected by the market price of the stock obtainable on exercise, rather than solely by the economics of the transaction entered into. Some believe that this produces a circular effect in that the reporting of earnings per share may then influence the market which, in turn, influences earnings per share. They believe that earnings per share should affect the market and not vice versa. They point out that the classification of convertible debentures and convertible preferred stocks is determined at time of issuance only and consequently subsequent fluctuations in the market prices of these securities do not affect primary earnings per share. Therefore, they believe that the dual, equally prominent presentation of primary and fully diluted earnings per share is most informative when the effect of options and warrants, other than those whose exercise price is substantially lower than market price at time of issuance, is included only in the fully diluted earnings per share which would be lower than primary earnings per share and thus would emphasize the potential dilution.

87. *Determination of equivalent common shares.* Some believe that the "treasury stock method" described in paragraph 36 of the Opinion is unsatisfactory and that other methods are preferable. Under one such method the number of equivalent shares is computed by reference to the relationship between the market value of the option or warrant and the market value of the related common stock. In general, it reflects the impact

of options and warrants on earnings per share whenever the option or warrant has a market value, and not only when the market price of the related common stock exceeds the exercise price (as does the treasury stock method).

88. *Measurement of effect of options and warrants.* Some believe that the effect of outstanding options and warrants on earnings per share should be computed by assuming exercise as of the beginning of the period and assuming some use of the funds so attributed to the issuer. The uses which have been suggested include application of such assumed proceeds to (a) reduce outstanding short or long term borrowings, (b) invest in government obligations or commercial paper, (c) invest in operations of the issuer or (d) fulfill other corporate objectives of the issuer. Each of these methods is felt by some to be the preferable approach. Many who support one of these methods feel that the "treasury stock method" is improper since (a) it fails to reflect any dilution unless the market price of the common stock exceeds the exercise price, (b) it assumes a hypothetical purchase of treasury stock which in many cases – due to the significant number of common shares involved – would either not be possible or be possible only at a considerably increased price per share, and (c) it may be considered to be the attribution of earnings assumed on the funds received – in which case the earnings rate for each issuer is a function of the price-earnings ratio of its common stock and is thus similar in result to an arbitrary assumption of a possibly inappropriate earnings rate.

89. Some believe that no increment in earnings should be attributed to the funds assumed to be received upon the exercise of options and warrants, particularly if such instruments are to be reflected in the computation of primary earnings per share, since the funds were not available to the issuer during the period.

Computational Methods—Convertible Securities

90. This Opinion concludes (paragraph 51) that the "if converted" method of computation should be used for primary earnings per share when convertible securities are considered

the equivalent of common stock. Some believe that this method does not properly reflect the actual circumstances existing during the period, and favor, instead, the so-called "two-class" method of computation. (See paragraphs 54-55.) Under the latter method, securities considered common stock equivalents are treated as common shares with a different dividend rate from that of the regular common shares. The residual security concept is based on common stock equivalence without the necessity of actual conversion; therefore, this method properly recognizes the fact that these securities receive a preferential distribution before the common stock — and also share in the potential benefits of the undistributed earnings through their substantial common stock characteristics in the same way as do the common shares. These securities are designed to achieve these two goals. Those who favor this method believe that the "if converted" method disregards the realities of what occurred during the period. Thus, in their view, the "if converted" method is a "pro-forma" method which assumes conversion and the elimination of preferential distributions to these securities; as such, it is not suitable for use in the computation of *primary earnings per share data,* since the assumed conversions did not take place and the preferential distributions did take place.

91. Those who favor the "two-class" method point out that it is considered appropriate in the case of certain participating and two-class common situations. In their view, the circumstances existing when common stock equivalents are outstanding are similar; therefore, use of this method is appropriate.

Recognition of Common Stock Equivalents in the Finanical Statements

92. This Opinion concludes (paragraph 39) that the designation of securities as common stock equivalents is solely for the purpose of determining primary earnings per share; no changes from present practice are recommended in the presentation of such securities in the financial statements. Some believe, however, that the financial statements should reflect a treatment of such securities which is consistent with the method used to determine earnings per share in the financial

statements. Accordingly, convertible debt considered to be a common stock equivalent would be classified in the balance sheet in association with stockholders' equity – either under a separate caption immediately preceding stockholders' equity, or in a combined section with a caption such as "Equity of common stockholders and holders of common stock equivalents". In the statement of income and retained earnings, interest paid on convertible debt considered a common stock equivalent would be shown as a "distribution to holders of common stock equivalents", either following the caption of "net income" in the statement of income or grouped with other distributions in the statement of retained earnings.

93. Some believe that the inconsistency of the positions taken on this matter in this Opinion is clearly evident in the requirement (paragraph 66) that, when a subsidiary has convertible securities which are common stock equivalents, the portion of the income of the subsidiary to be included in the consolidated statement of income of the parent and its subsidiaries should be computed disregarding the effect of the common stock equivalents, but that the computation of the primary earnings per share of the parent should reflect the effect of these common stock equivalents in attributing the income of the subsidiary to its various outstanding securities. This inconsistent treatment is, in the opinion of some, not only illogical but misleading.

APPENDIX C

ILLUSTRATIVE STATEMENTS

The following exhibits illustrate the disclosure of earnings per share data on the assumption that this Opinion was effective for all periods covered. The format of the disclosure is illustrative only, and does not necessarily reflect a preference by the Accounting Principles Board.

Exhibit A. This exhibit illustrates the disclosure of earnings per share data for a company with a simple capital structure (see paragraph 14 of this Opinion). The facts assumed for Exhibit A are as follows:

	Number of Shares	
	1968	*1967*
Common stock outstanding:		
Beginning of year	3,300,000	3,300,000
End of year	3,300,000	3,300,000
Issued or acquired during year	None	None
Common stock reserved under employee stock options granted	7,200	7,200
Weighted average number of shares	3,300,000	3,300,000

NOTE: Shares issuable under employee stock options are excluded from the weighted average number of shares on the assumption that their effect is not dilutive (see paragraph 14 of this Opinion).

EXHIBIT A

EXAMPLE OF DISCLOSURE OF EARNINGS PER SHARE
Simple Capital Structure

(Bottom of Income Statement)	*Thousands Except per share data*	
	1968	*1967*
Income before extraordinary item	$ 9,150	$7,650
Extraordinary item – gain on sale of property less applicable income taxes	900	–
Net Income	$10,050	$7,650
Earnings per common share:		
Income before extraordinary item	$ 2.77	$ 2.32
Extraordinary item	.28	–
Net Income	$ 3.05	$ 2.32

Exhibit B. This exhibit illustrates the disclosure of earnings per share data for a company with a complex capital structure (see paragraph 15 of this Opinion). The facts assumed for Exhibit B are as follows:

Market price of common stock. The market price of the common stock was as follows:

Average Price:	*1968*	*1967*	*1966*
First quarter	50	45	40
Second quarter	60	52	41
Third quarter	70	50	40
Fourth quarter	70	50	45
December 31 closing price	72	51	44

Cash dividends. Cash dividends of \$0.125 per common share were declared and paid for each quarter of 1966 and 1967. Cash dividends of \$0.25 per common share were declared and paid for each quarter of 1968.

Convertible debentures. 4% convertible debentures with a principal amount of \$10,000,000 due 1986 were sold for cash at a price of 100 in the last quarter of 1966. Each \$100 debenture was convertible into two shares of common stock. No debentures were converted during 1966 or 1967. The entire issue was converted at the beginning of the third quarter of 1968 because the issue was called by the company.

These convertible debentures were not common stock equivalents under the terms of this Opinion. The bank prime rate at the time the debentures were sold in the last quarter of 1966 was 6%. The debentures carried a coupon interest rate of 4% and had a market value of \$100 at issuance. The cash yield of 4% was not less than 66⅔% of the bank prime rate (see paragraph 33 of this Opinion). Cash yield is the same as the coupon interest rate in this case only because the market value at issuance was \$100.

Convertible preferred stock. 600,000 shares of convertible preferred stock were issued for assets in a purchase transaction at the beginning of the second quarter of 1967. The annual dividend on each share of this convertible preferred stock is \$0.20.

Each share is convertible into one share of common stock. This convertible stock had a market value of $53 at the time of issuance and was therefore a common stock equivalent under the terms of this Opinion at the time of its issuance because the cash yield on market value was only 0.4% and the bank prime rate was 5.5% (see paragraph 33 of this Opinion).

Holders of 500,000 shares of this convertible preferred stock converted their preferred stock into common stock during 1968 because the cash dividend on the common stock exceeded the cash dividend on the preferred stock.

Warrants. Warrants to buy 500,000 shares of common stock at $60 per share for a period of five years were issued along with the convertible preferred stock mentioned above. No warrants have been exercised. (Note that the number of shares issuable upon exercise of the warrants is less than 20% of outstanding common shares; hence paragraph 38 is not applicable.)

The number of common shares represented by the warrants (see paragraph 36 of this Opinion) was 71,428 for each of the third and fourth quarters of 1968 ($60 exercise price × 500,000 warrants = $30,000,000; $30,000,000 ÷ $70 share market price = 428,572 shares; 500,000 shares − 428,572 shares = 71,428 shares). No shares were deemed to be represented by the warrants for the second quarter of 1968 or for any preceding quarter (see paragraph 36 of this Opinion) because the market price of the stock did not exceed the exercise price for substantially all of three consecutive months until the third quarter of 1968.

Common stock. The number of shares of common stock outstanding were as follows:

	1968	*1967*
Beginning of year	3,300,000	3,300,000
Conversion of preferred stock	500,000	–
Conversion of debentures	200,000	–
End of year	4,000,000	3,300,000

Weighted average number of shares. The weighted average number of shares of common stock and common stock equivalents was determined as follows:

	1968	*1967*
Common stock:		
Shares outstanding from beginning of period	3,300,000	3,300,000
500,000 shares issued on conversion of preferred stock; assume issuance evenly during year	250,000	–
200,000 shares issued on conversion of convertible debentures at beginning of third quarter of 1968	100,000	–
	3,650,000	3,300,000
Common stock equivalents:		
600,000 shares convertible preferred stock issued at the beginning of the second quarter of 1967, excluding 250,000 shares included under common stock in 1968	350,000	450,000
Warrants: 71,428 common share equivalents outstanding for third and fourth quarters of 1968, i.e., one-half year	35,714	–
	385,714	450,000
Weighted average number of shares	4,035,714	3,750,000

The weighted average number of shares would be adjusted to calculate fully diluted earnings per share as follows:

	1968	*1967*
Weighted average number of shares	4.035,714	3,750,000
Shares applicable to convertible debentures converted at the beginning of the third quarter of 1968, excluding 100,000 shares included under common stock for 1968	100,000	200,000
Shares applicable to warrants included above	(35,714)	–
Shares applicable to warrants based on year-end price of $72 (see paragraph 42 of this Opinion)	83,333	–
	4,183,333	3,950,000

Income before extraordinary item and net income would be adjusted for interest expense on the debentures in calculating fully diluted earnings per share as follows:

	Thousands		
	Before Adjustment	*Interest, net of tax effect*	*After Adjustment*
1967: Net income	$10,300	$208	$10,508
1968:			
Income before extraordinary item	12,900	94	12,994
Net income	13,800	94	13,894

NOTES: (a) Taxes in 1967 were 48%; in 1968 they were 52.8%.
(b) Net income is before dividends on preferred stock.

EXHIBIT B

EXAMPLE OF DISCLOSURE OF EARNINGS PER SHARE
Complex Capital Structure

(Bottom of Income Statement)	*Thousands Except per share data*	
	1968	*1967*
Income before extraordinary item	$12,900	$10,300
Extraordinary item – gain on sale of property less applicable income taxes ..	900	–
Net Income	$13,800	$10,300
Earnings per common share and common equivalent share (note x):		
Income before extraordinary item..	$ 3.20	$ 2.75
Extraordinary item	.22	–
Net Income	$ 3.42	$ 2.75
Earnings per common share – assuming full dilution (note x):		
Income before extraordinary item..	$ 3.11	$ 2.66
Extraordinary item	.21	–
Net Income	$ 3.32	$ 2.66

EXHIBIT C

EXAMPLE OF NOTE X* TO EXHIBIT B

The $0.20 convertible preferred stock is callable by the company after March 31, 1972 at $53 per share. Each share is convertible into one share of common stock.

During 1968, 700,000 shares of common stock were issued on conversions: 500,000 shares on conversion of preferred stock and 200,000 on conversion of all the 4% convertible debentures.

Warrants to acquire 500,000 shares of the company's stock at $60 per share were outstanding at the end of 1968 and 1967. These warrants expire March 31, 1972.

Earnings per common share and common equivalent share were computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents outstanding during the year. The convertible preferred stock has been considered to be the equivalent of common stock from the time of its issuance in 1967. The number of shares issuable on conversion of preferred stock was added to the number

* The following disclosure in the December 31, 1968 balance sheet is assumed for this note:

	1968	*1967*
Long-term debt:		
4% convertible debentures, due 1986	–	$10,000,000
Stockholders' equity (note x):		
Convertible voting preferred stock of $1 par value, $0.20 cumulative dividend. Authorized 600,000 shares; issued and outstanding 100,000 shares (600,000 in 1967) ...	$ 100,000	$ 600,000
(Liquidation value $22 per share, aggregating $2,200,000 in 1968 and $13,200,000 in 1967)		
Common stock of $1 par value per share. Authorized 5,000,000 shares; issued and outstanding 4,000,000 shares (3,300,000 in 1967)	4,000,000	3,300,000
Additional paid-in capital	xxx	xxx
Retained earnings	xxx	xxx
	$ xxx	$ xxx

of common shares. The number of common shares was also increased by the number of shares issuable on the exercise of warrants when the market price of the common stock exceeds the exercise price of the warrants. This increase in the number of common shares was reduced by the number of common shares which are assumed to have been purchased with the proceeds from the exercise of the warrants; these purchases were assumed to have been made at the average price of the common stock during that part of the year when the market price of the common stock exceeded the exercise price of the warrants.

Earnings per common share and common equivalent share for 1968 would have been $3.36 for net income and $3.14 for income before extraordinary item had the 4% convertible debentures due 1986 been converted on January 1, 1968. (These debentures were called for redemption as of July 1, 1968 and all were converted into common shares.)

Earnings per common share—assuming full dilution for 1968 were determined on the assumptions that the convertible debentures were converted and the warrants were exercised on January 1, 1968. As to the debentures, net earnings were adjusted for the interest net of its tax effect. As to the warrants, outstanding shares were increased as described above except that purchases of common stock are assumed to have been made at the year-end price of $72.

Earnings per common share—assuming full dilution for 1967 were determined on the assumption that the convertible debentures were converted on January 1, 1967. The outstanding warrants had no effect on the earnings per share data for 1967, as the exercise price was in excess of the market price of the common stock.

APPENDIX D
DEFINITIONS OF TERMS

There are a number of terms used in discussion of earnings per share which have special meanings in that context. When used in this Opinion they are intended to have the meaning given in the following definitions. Some of the terms are not used in the Opinion but are provided as information pertinent to the subject of earnings per share.

Call price. The amount at which a security may be redeemed by the issuer at the issuer's option.

Cash yield. The cash received by the holder of a security as a distribution of accumulated or current earnings or as a contractual payment for return on the amount invested, without regard to the par or face amount of the security. As used in this Opinion the term "cash yield" refers to the relationship or ratio of such cash to be received annually to the market value of the related security at the specified date. For example, a security with a coupon rate of 4% (on par of $100) and a market value of $80 would have a cash yield of 5%.

Common stock. A stock which is subordinate to all other stocks of the issuer.

Common stock equivalent. A security which, because of its terms or the circumstances under which it was issued, is in substance equivalent to common stock.

Contingent issuance. A possible issuance of shares of common stock that is dependent upon the exercise of conversion rights, options or warrants, the satisfaction of certain conditions, or similar arrangements.

Conversion price. The price that determines the number of shares of common stock into which a security is convertible. For example, $100 face value of debt convertible into 5 shares of common stock would be stated to have a conversion price of $20.

Conversion rate. The ratio of (a) the number of common shares issuable upon conversion to (b) a unit of a convertible security. For example, a preferred stock may be convertible at the rate of 3 shares of common stock for each share of preferred stock.

Conversion value. The current market value of the common shares obtainable upon conversion of a convertible security, after deducting any cash payment required upon conversion.

Dilution (Dilutive). A reduction in earnings per share resulting from the assumption that convertible securities have been converted or that options and warrants have been exercised or other shares have been issued upon the fulfillment of certain conditions. (See footnote 2.)

Dual presentation. The presentation with equal prominence of two types of earnings per share amounts on the face of the income statement – one is primary earnings per share; the other is fully diluted earnings per share.

Earnings per share. The amount of earnings attributable to each share of common stock. For convenience, the term is used in this Opinion to refer to either net income (earnings) per share or to net loss per share. It should be used without qualifying language only when no potentially dilutive convertible securities, options, warrants or other agreements providing for contingent issuances of common stock are outstanding.

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

Fully diluted earnings per share. The amount of current earnings per share reflecting the maximum dilution that would have resulted from conversions, exercises and other contingent issuances that individually would have decreased earnings per share and in the aggregate would have had a dilutive effect. All such issuances are assumed to have taken place at the beginning of the period (or at the time the contingency arose, if later).

"If converted" method. A method of computing earnings per share data that assumes conversion of convertible securities as of the beginning of the earliest period reported (or at time of issuance, if later).

Investment value. The price at which it is estimated a convertible security would sell if it were not convertible, based upon its stipulated preferred dividend or interest rate and its other senior security characteristics.

Market parity. A market price relationship in which the market price of a convertible security and its conversion value are approximately equal.

Option. The right to purchase shares of common stock in accordance with an agreement, upon payment of a specified amount. As used in this Opinion, options include but are not limited to options granted to and stock purchase agreements entered into with employees. Options are considered "securities" in this Opinion.

Primary earnings per share. The amount of earnings attributable to each share of common stock outstanding, including common stock equivalents.

Redemption price. The amount at which a security is required to be redeemed at maturity or under a sinking fund arrangement.

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

Senior security. A security having preferential rights and which is not a common stock or common stock equivalent, for example, nonconvertible preferred stock.

Supplementary earnings per share. A computation of earnings per share, other than primary or fully diluted earnings per share, which gives effect to conversions, etc., which took place during the period or shortly thereafter as though they had occurred at the beginning of the period (or date of issuance, if later).

Time of issuance. The time of issuance generally is the date when agreement as to terms has been reached and announced, even though such agreement is subject to certain further actions, such as directors' or stockholders' approval.

Treasury stock method. A method of recognizing the use of proceeds that would be obtained upon exercise of options and warrants in computing earnings per share. It assumes that any proceeds would be used to purchase common stock at current market prices. (See paragraphs 36-38).

"Two-class" method. A method of computing primary earnings per share that treats common stock equivalents as though they were common stocks with different dividend rates from that of the common stock.

Warrant. A security giving 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 shares. The number of shares determined by relating (a) the portion of time within a reporting period that a particular number of shares of a certain security has been outstanding to (b) the total time in that period. Thus, for example, if 100 shares of a certain security were outstanding during the first quarter of a fiscal year and 300 shares were outstanding during the balance of the year, the weighted average number of outstanding shares would be 250.

CROSS-REFERENCE TABLE

In the following table, Opinion paragraphs, footnotes, and exhibits are listed in the first column followed by a citation to each Interpretation which references the Opinion paragraph, footnote, or exhibit. Citations in the second column refer to a page number in Part I. Citations in the third column refer to the number of an Interpretation in Part II.

CROSS-REFERENCE TABLE

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5		10	Closely Held Corporations
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6		9	Corporations and Financial Presentations Excepted
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