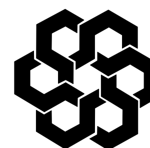

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**22 March 2007, London**
Project:	**Earnings Per Share**
Topic:	**Fair Value Method (Agenda Paper 11)**

PURPOSE OF THIS MEMORANDUM

1. The short-term convergence project relating to earnings per share (EPS) was added to the Boards agenda in September 2002. The Boards' objective in taking the project on was to eliminate the following differences between IAS 33 and Statement 128.

    a. Calculation of the number of incremental shares in diluted shares when applying the treasury stock method—FASB converged with the approach in IAS 33, in which quarterly and year-to-date diluted EPS calculations are computed using the average market price of common shares for the quarterly and year-to-date periods, respectively.

    b. Inclusion of mandatorily convertible shares in basic EPS—FASB converged with the IAS 33 approach that includes those instruments in basic EPS.

    c. Computation of the number of contingently issuable shares included in diluted EPS. That is, when only the manner of settlement (cash or shares) is contingent but the value to the holder is the same in either case, then the instrument may be settled in cash or shares and share settlement must be assumed—FASB converged with the IAS 33 approach.

d. Rebutting the presumption that instruments that can be settled in cash or shares will be settled in shares and, therefore, always will be included in diluted EPS—FASB tentatively decided, like IAS 33, to require that share settlement be assumed but proposed that the treasury stock be modified as a result.

2. Since 2002, the FASB has issued two Exposure Drafts of proposed changes to Statement 128. While FASB members affirmed past decisions to converge on issues (a)–(c) above, the FASB has yet to finalize those changes because of continuing discussions regarding issue (d) and questions about the project scope. The staff believes it is time for the Boards to bring this project to a close. The purpose of this memo is to present the Boards with a converged solution on issue (d) (i.e., instruments that can be settled in cash or shares and are classified as liabilities on an entity's balance sheet.) The Boards also will be receiving a second memo asking for decisions on the scope of this convergence project—i.e., whether certain other possible differences between IAS 33 and Statement 128 should be eliminated through this project and whether the project should be expanded to include certain improvements to existing, converged guidance.

INSTRUMENTS THAT CAN BE SETTLED IN CASH OR SHARES

Background

3. In prior Exposure Drafts and Board meetings on earnings per share, the staff proposed to alter the computation of the treasury stock method for instruments that could be settled in cash or shares and are recorded as liabilities on an entity's balance sheet. The staff's proposal was intended to (a) achieve convergence and (b) give a better reflection of the dilution to current shareholders of these instruments. The staff's proposal would have included the carrying value of these instruments (i.e., the liability amount) as an assumed proceeds of the treasury stock computation. In the process of considering that proposal, questions arose on whether the staff's proposal should be expanded to convertible debt and equity instruments, effectively doing away with the if-converted method. Those questions raised even more concerns surrounding convergence since the underlying accounting for convertible instruments is different between U.S. GAAP and IFRS. Rather than trying to address those questions, the staff has turned its focus back to the original convergence difference

between Statement 128 and IAS 33. That difference is created by the ability in Statement 128 to overcome the presumption that an instrument that can be settled in cash or shares will be settled in shares. IAS 33 does not include such an override. In the end, the staff suggested a new proposal (referred to as the fair value method) for instruments that can be settled in cash or shares, are classified as liabilities, and are marked-to-market each reporting period. The staff believes this method will achieve convergence and simplify the computation of EPS for this subset of instruments.

4. However, the fair value method does not solve all of the concerns. For instruments that can be settled in cash or shares, are classified as a liability, and are NOT marked-to-market each reporting period, the staff has maintained the method proposed in the latest Exposure Draft on Earnings per Share with one modification. That is, for instruments following the treasury stock method, to include as an assumed proceed the carrying amount of any liability not remeasured at each reporting period that would be extinguished upon exercise or share settlement. That method is referred to herein as the modified treasury stock method. The staff believes the use of this method would be significantly reduced by the proposed fair value method.

5. In order to achieve a converged solution on EPS, the staff has formed a group of FASB staff, IASB staff, FASB Board members, and IASB Board members. This group met on December 21, 2006, in order to review the staff's fair value method. At that meeting the group was supportive of using the fair value method for instruments that can be settled in cash or shares, are classified as a liability, and are marked-to-market each reporting period. Therefore, the remainder of this memo will describe in greater detail the staff analysis and recommendation to the Boards for the use of the fair value method and the modified treasury stock method.

Fair Value Method—Staff Analysis

Instruments Subject to the Treasury Stock Method

6. Statement 128 states that the objective of diluted EPS "…is consistent with that of basic EPS—to measure the performance of an entity over the reporting period—while giving effect to all **dilutive** potential common shares that were outstanding during the period…" (paragraph 11). IAS 33 states the same objective: "…to provide a measure of the interest of each ordinary share in the performance of an entity—while giving effect to all dilutive potential ordinary shares outstanding during the period" (paragraph 32).

7. In developing its recommendation, the staff considered the meaning of the phrase "measuring the performance of an entity". The staff thinks that the performance of an entity for the purpose of computing EPS means benefits received or the detriments incurred by the current shareholders during the period. The staff then considered whether the treasury stock method in Statement 128 and IAS 33 was the best method of reporting "performance of an entity" for all options, warrants, and their equivalents. As discussed below, the staff concluded it is not.

8. At the time Statement 128 and IAS 33 were issued, fair value accounting for derivative financial instruments was in its infancy. Therefore, carrying forward the dilution methods from Opinion 15 (that is, the treasury stock and if-converted methods) seemed to make sense. In the 10 years since those Statements were issued, however, fair value accounting has become more prevalent (e.g., some equity derivatives are classified as liabilities and measured at fair value, including share-based payments, and entities may elect to fair value their hybrid instruments or elect the use of the fair value option). In light of the increased use of fair value, the staff considered whether the mark-to-market adjustments required by fair value accounting better reflect the dilution of earnings attributable to common (ordinary) shares during a period than the treasury stock method. That is, for any instrument that is continuously measured at fair value, there would no longer be the need to include it in diluted EPS because the fair value marks would represent the dilution to current common (ordinary) shares.

9. Appendix A contains an example showing the computation of diluted EPS under the current treasury stock method (Example 1A) and the staff's proposed fair value method (Example 1B).

10. The fair value method focuses on the increase or decrease to the net assets of the company and, therefore, a current period credit or charge to income available to current shareholders while the treasury stock method is focused on the potential for additional shares to become outstanding. The staff believes both methods, in their own way, depict dilution to common shareholders. However, the fair value method represents a more realistic picture of dilution since it does not assume two hypothetical transactions. That is, the treasury stock method assumes the exercise of all in-the-money options and the subsequent repurchase of shares from the proceeds of those exercises.

11. While some observers may comment that the fair value adjustment is an appropriate alternative to the treasury stock method when the adjustment represents a reduction to income available to current shareholders, they are not as convinced when there is an increase in income available to current shareholders. That concern is most likely predicated on the fact that when a fair value adjustment increases income available to current shareholders it will result in a less dilutive impact on basic and diluted EPS than using the treasury stock method. To illustrate this point, the staff has prepared two examples in Appendix A. The first (Example 2A) assumes the use of the current treasury stock method and the second (Example 2B) assumes the fair value adjustment simply increases income available to current shareholders and no diluted EPS calculation is performed (i.e., basic and diluted EPS are the same).

12. The staff believes the fair value adjustment is, whether an increase or decrease in income available to current shareholders, representative of the benefits received or the detriment incurred by the current shareholders of issuing financial instruments. Said differently, the staff believes the fair value method is appropriate even if declines in an instrument's fair value results in a credit to income available to current shareholders. After all, the fair value decline is included in the computation of basic EPS; why would it not be included in the computation of diluted EPS? Therefore, the staff believes the fair value approach is an appropriate alternative to the treasury stock

method for instruments that are subject to the treasury stock method, have a share settlement feature, and are marked-to-market each reporting period.

Instruments Subject to the If-Converted Method

13. In addition to instruments that are subject to the treasury stock method (i.e., options, warrants, and their equivalents) the staff considered whether the fair value method also would apply to instruments that are subject to the if-converted method (i.e., convertible instruments). With the potential increase in fair value of convertible instruments (as a result of Statement 155 and the fair value option) the staff did not see a reason why the arguments for using the fair value method for options, warrants, and their equivalents also would not apply to a convertible instrument. Therefore, the staff believes that if a convertible instrument is recorded at fair value (**in its entirety**) each reporting period, then that instrument also would follow the fair value method and there would no longer be a need to include that instrument in diluted EPS because the fair value marks would represent the dilution to current common (ordinary) shares.

Instruments Subject to the Two-Class Method

14. One staff member has raised concerns about the ongoing need for the use of the two-class method. That is, if fair value is a better reflection of the dilution to common shareholders for a subset of instruments, then instruments that can be settled in cash or shares, are classified as liabilities, and are marked-to-market each reporting period but are considered a participating security should not have to compute basic or diluted EPS using the two-class method. That assertion is based on the notion that the participation feature (and therefore the expected distributions) is factored into the fair value of the instrument.

15. The arguments against doing away with the two-class method for instruments that can be settled in cash or shares, are classified as liabilities, are marked-to-market each reporting period, and are considered a participating security is that the fair value would include distributions the instrument is expected to receive during its contractual term. It would not, however, incorporate earnings that were not expected to be distributed (undistributed earnings) during the contractual term of the

participating instrument even though the participating instrument has a contractual right to receive those earnings if distributed. Therefore, the fair value method would appear to contradict the principle of the two-class method (i.e., how would current period earnings be allocated among the common [ordinary] shareholders and the participating instrument holders assuming that all the earnings for the period were distributed?). Opponents of this argument would highlight that if the fair value method is indeed a better reflection of dilution to current shareholders, then the principle of the two-class method (whether flawed or not) should not be applied to this subset of instruments.

Share-Based Payments

Fully Vested Awards

16. The staff also considered whether there is some unique aspect of share-based payment awards that can be settled in cash or shares and are classified as liabilities (therefore requiring mark-to market accounting each reporting period) that would cause the staff to reach a different conclusion in the computation of diluted EPS. That is, should a fully vested share-based payment award that can be settled in cash or shares, is classified as a liability, and is marked-to-market each reporting period also require no further computation in arriving at diluted EPS? The staff believes the arguments for using the fair value method for fully vested share-based payment awards would be similar to the arguments made for using the fair value method for instruments issued in a financing transaction described earlier in this memo. That is, the benefit received or the detriment incurred from settling an obligation by issuing an entity's equity is reflected in the trade-off between the increase or decrease in an entity's net assets and the dilution to common shareholders. Therefore, for a share-based payment award that can be settled in cash or shares that is classified as a liability and is marked-to-market each reporting period, this method would require no further computation in arriving at diluted EPS. The staff points out that this method is based on the notion that the granting of a share-based payment award is a compensation transaction and the holding of the award represents that of an equity holder. Therefore, the mark-to-market adjustment (of a full vested award) after the grant date (even though those adjustments are reported as increases or decreases in compensation cost) are the same

as if the holder received the instrument in a financing transaction. See Appendix A for illustrations of the computation of EPS for fully vested share-based payment awards under the current treasury stock method (Example 3A) and the fair value method (Example 3B).

Partially Vested Awards

17. Additionally, the staff considered whether the same arguments for the fair value method would apply to a partially vested share-based payment award that can be settled in cash or shares and is classified as a liability. The staff notes that during the vesting period of a share-based award that is classified as a liability, the recognition of compensation cost represents the portion of the award that has been earned during the period plus or minus the proportionate change in fair value of the award. The staff believes the proportionate mark-to-market adjustment for the portion of the award that is earned during a period is attempting to capture the same dilution as the treasury stock method. That is, under the treasury stock method the assumed proceeds include unrecognized compensation cost for a share-based payment award. The inclusion of the unrecognized compensation cost reduces the number of potential incremental shares, which the staff believes is an attempt to capture the dilution for only the portion of a share-based payment award that has been earned. Therefore, the staff believes the fair value method also is an appropriate alternative to the treasury stock method for partially vested share-based payment awards that can be settled in cash or shares and are classified as liabilities because both are attempting to capture the dilution related to the portion of the award that has been earned. See Appendix A for illustrations of the computation of EPS for share-based payment awards under the current treasury stock method (Example 4A) and the fair value method (Example 4B).

18. Some staff queried whether a liability award would be eligible for the fair value method if the compensation cost was capitalized in inventory. That is because, in those cases, the change in the fair value of the award may not have been recognized in earnings in the period it occurred (a portion of that cost may be in ending inventory). The staff recommends, primarily on the basis of simplicity and practicality, that such awards be included in diluted EPS using the fair value method. It would be onerous to (a) track the share-based payment awards for which compensation cost had been

capitalized as part of an asset and (b) the timing of when that compensation cost would reduce earnings available to common shareholders in a future period (e.g., as cost of goods sold).

Staff Recommendation

19. The staff believes that the fair value method is a better reflection of the dilutive effects of potential common (ordinary) shares for instruments that are subject to the treasury stock method, can be settled in cash or shares, are classified as liabilities, and are remeasured at fair value with the changes recognized in earnings. The fair value method avoids the need for a denominator adjustment for such awards. Accordingly, the staff recommends that the Boards amend Statement 128 and IAS 33 to exclude from the computation of diluted EPS any instrument subject to the treasury stock method that can be settled in cash or shares that is classified as a liability and is marked to fair value each reporting period with the change in fair value recognized in earnings. That recommendation also is supported by the belief that the fair value method would simplify the computation of diluted EPS.

20. In regard to instruments that are subject to the if-converted method, the staff would recommend the use of the fair value method for those instruments that can be settled in cash or shares, are classified as a liability, and are marked-to-market (**in their entirety**) each reporting period. That is, the staff would exclude those instruments from the computation of diluted EPS.

21. With respect to instruments that can be settled in cash or shares, are classified as liabilities, and are marked-to-market each reporting period but are considered a participating security, the staff remains undecided. On one hand, the staff believes the fair value of an instrument should capture all the expected distributions to that instrument and therefore represent the best reflection of potential dilution to current shareholders. On the other hand, the staff believes one of the objectives of basic EPS (i.e., the objective of the two-class method) is how the current period earnings would be distributed to the participating instrument holders and the common shareholders if all of the current period earnings were distributed. If that is indeed a principle of basic EPS, then the staff does not believe the fair value method would capture, in the

current period, the earnings that are not expected to be distributed but that the participating security is contractually entitled to receive.

22. In considering the recommendation to use the fair value method instead of the two-class method for the set of instruments described in paragraph 21 above, the staff observed there may be other instruments that only are included in the computation of EPS because they are considered a participating security; but they are not included in the set of instruments that can be settled in cash or shares, are classified as liabilities, and are marked-to-market each reporting period. For example, the staff considered a *straight debt* instrument that is considered a participating security and is marked-to-market each reporting period under Statement 159. If the Boards agree that the fair value method is a better reflection of dilution to common shareholders than the two-class method, then the same argument would hold for instruments that only are included in the computation of EPS because they are participating securities and marked-to-market each reporting period.

Issue 1(a): Do the Boards agree with the staff recommendation to use the fair value method for all instruments subject to the treasury stock method that can be settled in cash or shares, are classified as a liability on an entity's balance sheet, and are marked-to-market each reporting period through the income statement?

Issue 1(b): Do the Boards agree with the staff recommendation to use the fair value method for all instruments subject to the if-converted method that can be settled in cash or shares, are classified as a liability on an entity's balance sheet, and are marked-to-market each reporting period through the income statement?

Issue 1(c): Do the Boards believe instruments that can be settled in cash or shares, are classified as a liability on an entity's balance sheet, and are marked-to-market each reporting period through the income statement but are considered a participating security should continue to follow the two-class method or be scoped out of the computation of EPS under the fair value method?

Issue 1(d): Do the Boards believe all instruments that are considered participating securities and are marked-to-market each reporting period through the income

statement should continue to follow the two-class method or be scoped out of the computation of EPS under the fair value method?

Modified Treasury Stock Method—Staff Analysis

Instruments Subject to the Treasury Stock Method That Are NOT Marked-to-Market

23. While the fair value method achieves a converged solution on instruments that can be settled in cash or shares, are classified as liabilities, and are marked-to-market each reporting period, it does not address those same instruments that are NOT marked-to-market each reporting period. The staff believes those instruments that are subject to the treasury stock method and are NOT marked-to-market each reporting period should follow the modified treasury stock method that is described in the FASB's latest Exposure Draft on earnings per share with one modification. The modified treasury stock method would include the carrying value of the liability as an assumed proceed for instruments that are subject to the treasury stock method. The modification would require the use of the end-of-period market price of an entity's shares rather than the average market price in the computation of the treasury stock method. Along with this modification, and in order to remain consistent with the use of the end-of-period market price, the staff would suggest retaining the use of the end-of-period carrying value of the liability as an assumed proceed. The staff believes this modification would alleviate any questions on whether there is a numerator adjustment to the computation of the treasury stock method. Since these are instruments that are NOT marked-to-market each reporting period, that numerator adjustment would represent an add-back for the accretion of the liability to its settlement amount.

Convertible Instruments That Are NOT Marked-to-Market

24. The staff would like to be clear that, even though the fair value method would apply equally to instruments that are subject to the treasury stock or if-converted methods, it is recommending in this memo that the modified treasury stock method apply only to instruments included in EPS using the treasury stock method (i.e., options, warrants, and their equivalents) and those that are NOT marked-to-marked at each reporting period. The staff is recommending that the modified treasury stock method not be

applied to instruments that currently follow the if-converted method (i.e., convertible instruments). While some have argued in the past to extend the modified treasury stock method to include such convertible instruments, the staff observes that Statement 128 and IAS 33 are currently converged on the treatment of EPS for those instruments. We understand that some believe expanding use of the modified treasury stock method to all convertible instruments to be an improvement. However, this project was put on the agenda to eliminate differences, not to consider fundamental improvements to EPS. Some staff members also think that fundamental improvements to EPS might better be considered as part of or at the conclusion of the Board's liabilities and equity project.

All Instruments Subject to the Treasury Stock Method

25. If the Board agrees with the change to the computation of the treasury stock method from the average market price of an entity's shares to the end-of-period market price for instruments that can be settled in cash or shares, are classified as a liability, and are NOT marked-to-market each reporting period, then the staff would suggest making that change for all instruments that apply the treasury stock method. That is, in order achieve consistency in the application of the treasury stock method between instruments classified as liabilities and NOT marked-to-market and instruments classified as equity, the staff would suggest making the change to the end-of-period market price in the computation of the treasury stock method for all instruments.

26. The staff believes moving the computation of the treasury stock method to an end-of-period market price would resolve an inconsistency in Statement 128 that the exercise of options or warrants is assumed to occur at the beginning of the period (paragraph 17(a)) while the repurchase of treasury shares is assumed to occur over the period (i.e., the rational for using the average market price of an entity's shares in paragraph 107). The staff is unclear why one would assume exercise of an option or warrant and not the immediate repurchase of the treasury shares with the proceeds generated via exercise. The staff acknowledges that in the past, the Board changed the requirement of Opinion 15 to use the higher of the average or the end-of-period market prices based on the objective of EPS to measure EPS for the period based on period information. However, the staff believes using all end-of-period amounts (a)

provides consistent theoretical application of the treasury stock method and (b) provides current and future shareholders a better reflection of the performance of an entity over a reporting period (i.e., what the staff believes is the stated objective of diluted EPS in Statement 128).

27. To highlight the differences between the current treasury stock method and the staff's modified treasury stock method of using the end-of-period amounts for instruments classified as equity, the staff has prepared two examples in Appendix A. The first example (Example 5A) assumes the use of the current treasury stock method and the second (Example 5B) assumes the use of end-of-period information in computing diluted EPS using the modified treasury stock method.

Staff Recommendation

28. The staff recommends for any instruments subject to the treasury stock method that can be settled in cash or shares, are classified as a liability, and NOT marked to fair value each reporting period to use the modified treasury stock method. That is, to (a) include the end-of-period carrying value of the liability as an assumed proceed and (b) use the end-of-period market price in the computation of the treasury stock method. Additionally, the staff recommends revising the current treasury stock method to use the end-of-period market prices for ALL instruments that are required to use the treasury stock method and NOT marked to fair value each reporting period. That would include instruments (including share-based payment awards) that can be settled in cash or shares, are classified as either equity or as a liability, and are NOT marked-to-market each reporting period. The staff acknowledges this would be a significant change to the computation of diluted EPS, but it believes this is a better representation of the objective of diluted EPS (i.e., to measure the performance of an entity). To summarize the effect of all of the staff recommendations on the computation of diluted EPS to various instruments, the staff has prepared a table in Appendix B of this memo.

29. If the Board agrees with the staff recommendation, then the staff believes any instrument subject to the treasury stock method that is classified as a liability (and NOT marked-to-market) and will be settled by issuing an equal value of shares for the

current carrying value of the liability should always result in no additional dilution. Consider, for example, a fixed liability that will be settled in a variable number of shares for the carrying value of the liability. By including the carrying value of the liability as an assumed proceed the number of shares issued should never be greater than the number of shares repurchased with the assumed proceed. Therefore, if the Board agrees with the staff recommendation, then the staff would suggest scoping these instruments out of the computation of diluted EPS rather than requiring an entity to compute diluted EPS for an instrument that should always be anti-dilutive.

Issue 2(a): Does the Board agree with the staff recommendation to use the modified treasury stock method for instruments that are (a) subject to the treasury stock method, (b) can be settled in cash or shares, and (c) are NOT marked to fair value each reporting period?

Issue 2(b): Does the Board agree with the staff recommendation to use the end-of-period market price in the computation of EPS for ALL instruments that are subject to the treasury stock method?

Issue 2(c): Does the Board agree with the staff recommendation to scope out of the computation of diluted EPS instruments that are subject to the treasury stock method that are classified as a liability (and NOT marked-to-market) and will be settled by issuing an equal value of shares for the current carrying value of the liability?

APPENDIX A

Example 1A: Option Accounted for As a Liability—CURRENT TREASURY STOCK METHOD

An entity has 2,000,000 shares of common stock outstanding for the entire fiscal year-ended December 31, 2005. Also outstanding are 125,000 written call options that were issued in 2004 for CU750,000 that can be settled in 4 years by issuing the entity's own equity or paying cash for the intrinsic value of the option at settlement. The exercise price of the option is CU40. The entity has no other common share equivalents. 2005 net income was CU8,000,000 (inclusive of a charge for the change in fair value of the call option of CU150,000, net of tax); and has a combined statutory tax rate of 40 percent. The average market price of the entity's common shares for the year-ended December 31, 2005, was CU44 per share and the fair value of the written call option as of December 31, 2004, and 2005, was CU5 and CU7, respectively.

The call option is a liability that is remeasured to fair value with the change in fair value reported in net income. The fair value of the written call option at December 31, 2004, was CU625,000 (125,000 options × CU5 fair value) and at December 31, 2005, was CU875,000 (125,000 options × CU7 fair value).

Basic EPS computation for the year-ended December 31, 2005:

Net income (inclusive of a charge for the change in fair value of the call option of CU150,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Basic EPS	**CU4.00**

Diluted EPS computation for the year-ended December 31, 2005:

Computation of assumed proceeds	
Exercise price of the award (125,0000 x CU40)	CU5,000,000
Assumed proceeds	CU5,000,000
Assumed repurchase of shares	
Repurchase shares at average market price (5,000,000 ÷ 44)	113,636
Incremental shares (125,000 – 113,636)	11,364
Net income (inclusive of a charge for the change in fair value of the call option of CU150,000, net of tax)	CU8,000,000
Plus: Change in fair value, net of tax [(875,000 – 625,000) × (1 - .40 tax rate)]	150,000
Total	CU8,150,000
Weighted-average shares	2,000,000
Plus: Incremental shares from assumed conversion	11,364
Total	2,011,364

Diluted EPS	**CU4.05**[1]

Example 1B: Option Accounted for As a Liability—PROPOSED FAIR VALUE METHOD

Basic and Diluted EPS computation for the year-ended December 31, 2005:

Net income (inclusive of a charge for the change in fair value of the call option of CU150,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Basic and Diluted EPS	**CU4.00**

[1] This instrument is anti-dilutive and therefore basic and diluted EPS would be reported as CU4.00 per common share.

Example 2A: Option Accounted for As a Liability—CURRENT TREASURY STOCK METHOD

An entity has 2,000,000 shares of common stock outstanding for the entire fiscal year-ended December 31, 2005. Also outstanding are 125,000 written call options that were issued in 2004 for CU750,000 that can be settled in 4 years by issuing the entity's own equity or paying cash for the intrinsic value of the option at settlement. The exercise price of the option is CU40. The entity has no other common share equivalents. 2005 net income was CU8,225,000 (inclusive of a benefit for the change in fair value of the call option of CU225,000, net of tax); and has a combined statutory tax rate of 40 percent. The average market price of the entity's common shares for the year-ended December 31, 2005, was CU44 per share and the fair value of the written call option as of December 31, 2004, and 2005, was CU8 and CU5, respectively.

The call option is a liability remeasured at fair value. The liability as of December 31, 2004, was CU1,000,000 (125,000 options × CU8 fair value) and was CU 625,000 as of December 31, 2005, a CU625,000 (125,000 options × CU5 fair value).

Basic EPS computation for the year-ended December 31, 2005:	
Net income (inclusive of a benefit for the change in fair value of the call option of CU225,000, net of tax)	CU8,225,000
Weighted-average shares	2,000,000
Basic EPS	**CU4.11**
Diluted EPS computation for the year-ended December 31, 2005:	
Computation of assumed proceeds	
Exercise price of the award	CU5,000,000
Assumed proceeds	CU5,000,000
Assumed repurchase of shares	
Repurchase shares at average market price (5,000,000 ÷ 44)	113,636
Incremental shares (125,000 – 113,636)	11,364
Net income (inclusive of a benefit for the change in fair value of the call option of CU225,000, net of tax)	CU8,225,000
Plus: Change in fair value, net of tax [(625,000 – 1,000,000) × (1 - .40 tax rate)]	(225,000)
Total	CU8,000,000
Weighted-average shares	2,000,000
Plus: Incremental shares from assumed conversion	11,364
Total	2,011,364
Diluted EPS	**CU3.98**

Example 2B: Option Accounted for As a Liability—PROPOSED FAIR VALUE METHOD

Basic and Diluted EPS computation for the year-ended December 31, 2005:

Net income (inclusive of a benefit for the change in fair value of the call option of CU225,000, net of tax)	CU8,225,000
Weighted-average shares	2,000,000
Basic and Diluted EPS	**CU4.11**

Example 3A: Fully-Vested Share-Based Payment Award Accounted for As a Liability—CURRENT TREASURY STOCK METHOD

An entity has 2,000,000 shares of common stock outstanding for the entire fiscal year-ended December 31, 2005. On January 1, 2004, the entity issued 125,000 share settled employee share options that have features that make them a liability for financial reporting purposes. Each award had a grant-date fair value of CU6. The awards vest at the end of the first year of service (cliff vesting and have an exercise price of CU40.) The entity has no other common share equivalents. The entity's 2005 net income was CU8,000,000 (inclusive of compensation cost of CU150,000, net of tax); and the entity has a combined statutory tax rate of 40 percent. The average market price of the entity's common shares for the year-ended December 31, 2005, was CU56 per share and the fair value of the awards as of December 31, 2004, and 2005, were CU8 and CU10, respectively.

The award liability had a carrying amount of CU1,000,000 at December 31, 2004, (125,000 options × CU8 fair value) and CU1,250,000 at December 31, 2005, (125,000 options × CU10 fair value).

Basic EPS computation for the year-ended December 31, 2005:

Net income (inclusive of compensation cost of CU150,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Basic EPS	**CU4.00**

Diluted EPS computation for the year-ended December 31, 2005:

Computation of assumed proceeds	
Exercise price of the award	CU5,000,000
Tax benefit that would be recognized in additional paid-in capital	
{[(56 – 40) – 10] × 125,000} × 40%	300,000
Assumed proceeds	CU5,300,000
Assumed repurchase of shares	
Repurchase shares at average market price (5,300,000 ÷ 56)	94,643
Incremental shares (125,000 – 94,643)	30,357
Net income (inclusive of compensation cost of CU150,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Plus: Incremental shares from assumed conversion	30,357
Total	2,030,357
Diluted EPS	**CU3.94**

Example 3B: Fully-Vested Share-Based Payment Award Accounted for As a Liability—PROPOSED FAIR VALUE METHOD

Basic and Diluted EPS computation for the year-ended December 31, 2005:

Net income (inclusive of compensation cost of CU150,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Basic and Diluted EPS	**CU4.00**

Example 4A: Partially Vested Share-Based Payment Award Accounted for As a Liability—CURRENT TREASURY STOCK METHOD

An entity has 2,000,000 shares of common stock outstanding for the entire fiscal year-ended December 31, 2005. On January 1, 2004, the entity issued 125,000 share settled employee share options that have features that make them a liability for financial reporting purposes. Each award had a grant-date fair value of CU6. The awards vest at the end of the fourth year of service (cliff vesting and have an exercise price of CU40.) The entity has no other common share equivalents. The 2005 net income was CU8,000,000 (inclusive of compensation cost of CU225,000, net of tax); and the entity has a combined statutory tax rate of 40 percent. The average market price of the entity's common shares for the year-ended December 31, 2005, was CU56 per share and the fair value of the awards as of December 31, 2004, and 2005, were CU8 and CU10, respectively.

The award liability had a carrying amount of CU250,000 at December 31, 2004, (125,000 options × CU8 fair value × 25% vested) and CU625,000 at December 31, 2005, (125,000 options × CU10 fair value × 50% vested).

Basic EPS computation for the year-ended December 31, 2005:	
Net income (inclusive of compensation cost of CU225,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Basic EPS	**CU4.00**
Diluted EPS computation for the year-ended December 31, 2005:	
Computation of assumed proceeds	
Exercise price of the award	CU5,000,000
Average unrecognized compensation cost [(750,000 + (1,250,000 – 625,000)) ÷ 2]	687,500
Tax benefit that would be recognized in additional paid-in capital {[(56 – 40) – 10] × 125,000} × 40%	300,000
Assumed proceeds	CU5,987,500
Assumed repurchase of shares	
Repurchase shares at average market price (5,987,500 ÷ 56)	106,920
Incremental shares (125,000 – 106,920)	18,080
Net income (inclusive of compensation cost of CU225,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Plus: Incremental shares from assumed conversion	18,080
Total	2,018,080
Diluted EPS	**CU3.96**

Example 4B: Partially Vested Share-Based Payment Award Accounted for As a Liability—PROPOSED FAIR VALUE METHOD

Basic and Diluted EPS computation for the year-ended December 31, 2005:

Net income (inclusive of compensation cost of CU225,000, net of tax)	CU8,000,000
Weighted-average shares	2,000,000
Basic and Diluted EPS	**CU4.00**

Example 5A: Option Accounted for As Equity—CURRENT TREASURY STOCK METHOD

An entity has 2,000,000 shares of common stock outstanding for the entire fiscal year-ended December 31, 2005. On January 1, 2004, the entity issued 125,000 written call options for CU750,000 that can be settled in 4 years by issuing the entity's own equity and, thus, is classified as equity for financial reporting. The exercise price of the option is CU40. The entity has no other common share equivalents. 2005 net income was CU8,000,000. Further assume the average market price of the entity's common shares for the year-ended December 31, 2005, was CU48 per share.

Basic EPS computation for the year-ended December 31, 2005:

Net income	CU8,000,000
Weighted-average shares	2,000,000
Basic EPS	**CU4.00**

Diluted EPS computation for the year-ended December 31, 2005:

Computation of assumed proceeds	
Exercise price of the award	CU5,000,000
Assumed proceeds	CU5,000,000
Assumed repurchase of shares	
Repurchase shares at average market price (5,000,000 ÷ 48)	104,167
Incremental shares (125,000 – 104,167)	20,833
Net income	CU8,000,000
Weighted-average shares	2,000,000
Plus: Incremental shares from assumed conversion	20,833
Total	2,020,833
Diluted EPS	**CU3.96**

Example 5B: Option Accounted for As Equity—MODIFIED TREASURY STOCK METHOD

Assume that an entity has 2,000,000 shares of common stock outstanding for the entire fiscal year-ended December 31, 2005; current period net income of CU8,000,000. On January 1, 2004, the entity issued 125,000 written call options for CU750,000 that can be settled in 4 years by issuing the entity's own equity. The exercise price of the option is CU40. The entity has no other common share equivalents. Further assume the average and end-of-period market price of the entity's common shares for the year-ended December 31, 2005, were CU48 and CU50 per share, respectively. What amounts would the entity report under the PROPOSED TREASURY STOCK method for fiscal year 2005 in computing diluted EPS?

Basic EPS computation for the year-ended December 31, 2005:

Net income	CU8,000,000
Weighted-average shares	2,000,000
Basic EPS	**CU4.00**

Diluted EPS computation for the year-ended December 31, 2005:

Computation of assumed proceeds	
Exercise price of the award	CU5,000,000
Assumed proceeds	CU5,000,000
Assumed repurchase of shares	
Repurchase shares at end-of-period market price (5,000,000 ÷ 50)	100,000
Incremental shares (125,000 – 100,000)	25,000
Net income	CU8,000,000
Weighted-average shares	2,000,000
Plus: Incremental shares from assumed conversion	25,000
Total	2,025,000
Diluted EPS	**CU3.95**

APPENDIX B

	Method Used in the Computation of Diluted EPS under Staff Recommendations
Financing Instruments:	
Instruments that will be settled in shares and, therefore, are classified as equity and not marked-to-market each reporting period.	Modified treasury stock method (However, treasury stock method would not include end-of-period carrying value of the instrument as an assumed proceed since the instrument is classified in equity)
Instruments subject to the treasury stock method that can be settled in cash or shares and are classified as equity and, therefore, ARE NOT marked-to-market each reporting period.	Modified Treasury stock method
Instruments subject to the treasury stock method that can be settled in cash or shares, are classified as a liability, NOT marked-to-market each reporting period, and will be settled by issuing an equal value of shares for the current carrying value of the liability.	Scoped out of the computation of diluted EPS

Instruments that can be settled in cash or shares and are classified as a liability and NOT marked-to-market each reporting period.	Modified treasury stock or if-converted methods
ALL instruments that can be settled in cash or shares and are (a) classified as a liabilities and (b) marked-to-market each reporting period.	Fair value method (i.e., no computation of diluted EPS)
Share-Based Payment Awards:	
Awards that will be settled in shares and are classified as equity and, therefore, compensation cost is based on grant-date fair value.	Modified treasury stock method (However, treasury stock method would not include end-of-period carrying value of the award as an assumed proceed since the award is classified in equity)
Awards that can be settled in cash or shares and are classified as equity and, therefore, compensation cost is based on grant-date fair value.	Modified treasury stock method (However, treasury stock method would not include end-of-period carrying value of the award as an assumed proceed since the award is classified in equity)
Awards that can be settled in cash or shares and are classified as liabilities and, therefore, are marked-to-market each reporting period.	Fair value method (i.e., no computation of diluted EPS)