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Ms. Suzanne Q. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

> Proposed Statement of Financial Accounting Standards, Earnings per Share, an amendment of FASB Statement No. 128 File Reference No. 1240-001

Dear Ms. Bielstein:

Ernst & Young appreciates the opportunity to respond to the FASB's (revised) Proposed Statement of Financial Accounting Standards, Earnings per Share, an amendment of FASB Statement No. 128 (the "Proposed Amendment"). We are supportive of the efforts of the FASB and the International Accounting Standards Board to harmonize their accounting standards and encourage both Boards to continue their efforts in this regard. While we support certain aspects of the Proposed Amendment, we believe that certain of the proposed changes highlight and, in some cases, exacerbate existing flaws in the earnings per share model.

We believe that the existing earnings per share model is not based on a set of clearly articulated underlying principles that can be consistently applied in similar, but not identical, circumstances. As a result, we recommend that the FASB expand this project and climinate as many of the Statement's inconsistencies as possible. While we understand the FASB's desire to delay a wholesale reconsideration of Statement 128 until it completes its project on liabilities and equity, we believe it would be a mistake to delay needed changes to Statement 128 pending the completion of a project that involves many difficult issues that the FASB is unlikely to resolve soon.

Although some may object to equity market participants' focus on earnings per share, it nonetheless remains true that it is a highly scrutinized measurement of performance and is a critical determinant of the price of equity securities. Accordingly, we believe the inconsistencies in Statement 128 warrant greater consideration by the FASB within this project, particularly since the FASB has already moved the project beyond strict convergence with International Accounting Standards (i.e., its decision regarding the application of the treasury stock method to instruments classified as liabilities).

Statement 128 includes four primary approaches to determine whether financial instruments result in earnings per share dilution:



Ms. Suzanne Q. Bielstein November 21, 2005 Page 2

- 1. The treasury stock method for options and most forwards, which results in dilution only when an option or forward is "in the money" to the counterparty based on the average stock price during the period. While we believe that this represents a logical approach to measuring dilution for such instruments, the calculation includes certain adjustments to the assumed proceeds of exercise that in some cases are difficult to explain (i.e., the requirement to reduce the assumed proceeds of exercise for write-offs of deferred tax assets resulting from share-based payments if those deferred tax assets would be written off to equity, but assumed proceeds are not reduced if the deferred tax asset would be written off to income tax expense).
- 2. The if-converted method, which assumes conversion of a convertible security at the beginning of the period, regardless of whether the conversion option is in the money.
- 3. Contingently issuable shares, which result in dilution only if the contingency is met as of the end of the reporting period. If the contingency has not been met, no dilution results, even if it is highly probably that the contingency will be met and, in the case of share-based payments to employees, the issuer is recognizing compensation cost based on that probability assessment.
- 4. Instruments that may be settled in cash or shares, which are presumed to be settled in shares even if share settlement is permitted only upon the occurrence of a contingency that is considered to have a remote likelihood of occurrence. If the same remote contingency related to contingently issuable shares, no dilution would result until the unlikely contingent event occurs.

The above approaches seem to run the gamut from extreme dilution (models 2 and 4) to less or no dilution (model 3) even though an instrument subject to one model may have very similar economics to an instrument subject to another model (e.g., convertible debt versus debt with detachable warrants). While the FASB states in the basis for conclusions that "the objective of computing diluted EPS, as stated in paragraph 79 of Statement 128, requires that all potentially dilutive shares be reflected in the computation of diluted EPS," it seems clear that this objective is not consistently applied in all of the above models. We believe these inconsistencies have led to many of the recent practice issues (e.g., accounting arbitrage between contingently issuable share versus if-converted methods, or between if-converted and treasury stock methods) and the difficulty of applying Statement 128 without consulting with experts on this topic

Additionally, the earnings per share model includes an overriding principle of no antidilution, which the FASB chose to deviate from with respect to mandatorily convertible securities.

Finally, the earnings per share model requires the use of the "two-class method" to allocate earnings among securities that participate in dividends. However, that model is difficult to apply outside the context of a C-Corporation with multiple classes of common stock or other perpetual



Ms. Suzanne Q. Bielstein November 21, 2005 Page 3

equity instruments, and, at times, results in allocations in a manner significantly different from expected distributions of earnings. These challenges are particularly apparent when the participating securities involve partnerships or similar entities that have complex distribution requirements or participating instruments that have finite lives and are not convertible into common stock or its equivalent.

If the FASB concludes it is not the appropriate time for a wholesale reconsideration of Statement 128 (because, for example, it expects to consider even more fundamental changes to the earnings per share model in connection with the liabilities and equity project or its project on financial performance reporting), we have the following recommendations on the Proposed Statement that may reduce some of the inconsistencies in the model, as well as other specific comments about the proposed changes to Statement 128.

## **Application of the Treasury Stock Method**

We generally support the proposed changes to the application of the treasury stock method, including the inclusion of the carrying value of the instrument in the assumed proceeds if the instrument is classified as a liability. However, we disagree with the FASB's decision not to extend this concept to convertible debt instruments.

We believe that the current application of the if-converted method is inconsistent with the inclusion of the carrying value of a liability within assumed proceeds for purposes of the treasury stock method. We recommend that the FASB revise the calculation of the dilutive effect of convertible securities to increase consistency with the treasury stock method. This could be accomplished by including the carrying value of the debt instrument in the assumed proceeds of conversion. Although we acknowledge that this approach would effectively include the initial relative fair value of the embedded warrant (that generally is not bifurcated) within the assumed proceeds, we believe that is a consequence of the current accounting model that also results in the recognition of interest cost that is less than the economic interest cost associated with the debt component. This approach will provide for greater symmetry between the earnings per share impacts of freestanding warrants and those embedded in convertible debt instruments, and eliminate the accounting motivations associated with complex convertible securities such as those addressed in EITF Issues 90-19 and 04-8. More specifically, these approaches would help avoid the potential for significant dilution resulting from convertible instruments that are deeply out of the money, which we do not believe is a useful presentation for current or potential investors in the issuer's equity securities.

Regarding the mechanics of the treasury stock calculation for instruments classified as liabilities, we believe that the amount of the liability included in the assumed proceeds should be based on the average carrying value of the instrument during the period (as opposed to the use of the end-of-period carrying value as proposed by the FASB). We believe that this approach is more consistent with the use of the average stock price in the treasury stock calculation, as well as the



Ms. Suzanne Q. Bielstein November 21, 2005

Page 4

adjustment to the assumed proceeds for the average unrecognized compensation cost during the period. Further, for instruments that are reported at fair value, it will avoid the need to perform the treasury stock calculation because such instruments would never be dilutive under this approach. We do not believe it is appropriate to recognize dilution simply because the rules for the application of the treasury stock method specify different dates for measuring the assumed proceeds and the shares that could be purchased with those proceeds.

We also recommend that the guidance for adjusting the assumed proceeds for the carrying value of liability instruments should be included in paragraph 17 of Statement 128. We are concerned that including that guidance under the heading "Share-Base Payment Arrangements" may result in unintentional misapplication of the standard because the guidance does not apply solely to share-based payments, and companies without share-based payments may inadvertently miss this guidance.

## **Mandatorily Convertible Instruments**

We do not agree with the FASB's conclusion that the if-converted method should be applied to mandatorily convertible securities (for purposes of both basic and diluted earnings per share) even if the result is anti-dilutive. As a result of the FASB's decision, the interest rate on convertible debt would have no impact on earnings per share. That is, earnings per share would not differ if an instrument paid interest of two percent or 20 percent, even though presumably paying 20 percent interest would require fewer shares to be delivered for the same initial purchase price and, therefore, the instrument actually would result in less dilution. The FASB justified its decision as follows:

The Board reasoned that because the conversion into shares of mandatorily convertible instruments is contingent only on the passage of time, those instruments should be included in the computation of basic EPS, whether the effect of including the additional shares is dilutive or antidilutive. The Board noted that the distinction between dilutive and antidilutive effects is not pertinent to this decision, which concerns basic EPS computation.

We note that the basic earnings per share model does not contemplate adjustments to the numerator of the earnings per share calculation (except for deductions of preferred stock dividends or earnings allocated to participating securities). If the FASB wishes to emphasize consistency with the contingently issuable shares model, it may wish to consider an alternative model for mandatorily convertible securities in which the shares are simply added to the denominator of the earnings per share calculation without adjustment to the numerator (because the company will incur the interest cost and, based only on the passage of time, shares will be delivered).



Ms. Suzanne Q. Bielstein November 21, 2005 Page 5

If the FASB does not change the proposed model for mandatorily convertible instruments, we believe additional guidance is needed for those instruments that will result in the delivery of a variable number of shares subject to a minimum. In that case, the Proposed Statement indicates that only the minimum number of shares should be included in the denominator of the earnings per share calculation, but gives no guidance regarding the adjustment to the numerator when applying the if-converted method for only a portion of the instrument.

## Instruments That May Be Settled in Cash or Shares

We agree with the FASB's conclusion that for earnings per share purposes share settlement should be presumed for instruments that may be settled in cash or shares at the option of either party. However, we believe that the approach for instruments that can be settled in shares only upon the occurrence of a specified event should be made consistent with the approach for contingently issuable shares. Under the existing contingently issuable shares model, issuance of shares would be assumed for earnings per share purposes only when the contingency has been satisfied (or would be satisfied if the end of the period were the end of the contingency period). We would support changing the models for both contingently issuable shares and contingent share settlement of an instrument that may be settled in cash or shares such that the shares are included in the denominator of the earnings per share calculation if it is probable that the contingency will be satisfied. We note that this assessment of probability already must be made for purposes of recognition of compensation cost for share-based payments to employees subject to performance conditions. In many cases, employers recognize compensation cost or a sharebased payment because achievement of the performance condition is probable, yet they are prohibited from including the shares underlying the payment in the denominator of the diluted earnings per share calculation.

## **Transition**

If the scope of the Proposed Statement remains unchanged and a final statement is issued before the end of 2005, we do not object to the proposed transition. However, if the scope of the final statement is broader than the Proposed Statement, or the issuance of a final statement is delayed beyond the end of 2005, we recommend that transition be reconsidered and additional transition time be provided.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst + Young LLP