



BDO Seidman, LLP
Accountants and Consultants

233 North Michigan Avenue
Suite 2500
Chicago, Illinois 60601
Phone 312-616-4661
Fax 312-856-9019

December 14, 2006

Mr. Lawrence Smith
Director TA&I--FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 3

Dear Mr. Smith:

BDO Seidman, LLP is pleased to offer comments on the Proposed FASB Staff Position (FSP) EITF 03-6-a.

We disagree with the Proposal. As discussed in more detail in this letter and the attached example, we believe that the proposed approach reflects excessive dilution in basic eps for two reasons:

- The two-class method double counts the dividends or dividend equivalents.
- The two-class method reflects 100% of dilution immediately upon grant, in contrast to the historical treatment in diluted eps in which dilution is reflected gradually as the employee renders service.

Under FASB Statement No. 123(R), the fair value of a share-based award with dividend rights is higher than the fair value of an otherwise similar award without such rights. The higher fair value of an award with dividend rights is charged to compensation expense over the employee's service period, reducing net income and reducing the numerator of eps. We believe that the higher compensation expense appropriately captures the dilutive impact of the dividend rights in basic eps.

The proposed FSP suggests that such an award should be considered a participating security and that basic eps should be computed using the two-class method. When dividends are declared, the already reduced net income would be allocated between ordinary common shares and the share-based payment award. We believe this computation double counts the dividend as compensation cost and as distributed earnings, the same as the staff describes in paragraph 7 of the proposed FSP.

Furthermore, under the two-class method, undistributed earnings also would be allocated between ordinary common shares and the share-based payment award. This further reduces basic eps. As illustrated in the attached example, the immediate effect on basic

eps is even more dilutive than the dilution under the treasury stock method in the final year of the vesting period.

Commentary on the Attached Example

The attached example is intended to illustrate these points. It uses nonvested shares rather than options for simplicity, but the effects would be similar for options.

Case 1 illustrates basic and diluted eps for nonvested shares with no dividend rights. Because the shares do not receive dividends prior to vesting, the fair value of the shares is less than the market price of an ordinary common share by the present value of the dividends expected to be declared during the vesting period. The estimate of fair value is based on the guidance in paragraphs 205 and 206 of original Statement 123. Although we could not find similar guidance in Statement 123(R), the theory that the market price of a share represents the present value of the expected cash flows to the shareholder continues to be valid, and a nonvested share that does not receive expected cash dividends during the vesting period has a fair value less than an ordinary share. As a result, the estimated fair value of the 100 nonvested shares is lower than the market price by \$4.40 per share or \$440 in the aggregate.

Basic eps, computed as net income divided by average shares outstanding, is \$4.09 per share during the five-year vesting period.

Diluted earnings per share is computed using the treasury stock method. The proceeds to be considered for the hypothetical purchase of treasury shares consist of the average unamortized compensation each year. As the employees perform services and the compensation is amortized, the number of hypothetical treasury shares decreases and the number of adjusted shares outstanding increases. Diluted eps is \$4.02 in Year 1 and decreases to \$3.75 in Year 5.

At the end of Year 5, the shares vest. For Year 6 and future years, there is no further compensation expense from this award, and the number of shares outstanding increases from 1,000 to 1,100. This results in basic and diluted eps in Year 6 and future years of \$4.55, unless the company makes a new award to maintain a similar level of compensation expense.

Case 2 illustrates basic and diluted eps for nonvested shares that receive the same dividends (\$.25 per quarter, or \$1.00 per year) as ordinary common shares. The fair value of these nonvested shares equals the market price of the common shares. As a result, compensation expense in Case 2 is higher than in Case 1 by \$88 per year or \$440 in the aggregate for the five years. This results in basic eps of \$4.00 per share, \$.09 less than basic eps in Case 1. We believe this \$.09 difference appropriately captures the economic impact of the dividend rights in Case 2.

If we apply the two-class method, basic eps falls to \$3.64 per share, or 11% less than basic eps in Case 1. This result overstates the economic effect of paying a \$1 per share dividend during the five-year vesting period and is not representationally faithful. Note also that \$3.64 per share is lower than diluted eps for any of the five years of the vesting period in Case 1. The reason the two-class method is so dilutive is that the method requires undistributed earnings to be allocated between the classes in the same manner as distributed earnings. This assumption is unrealistic for a nonvested share that has a five-year vesting period. It is unlikely that the undistributed earnings would be distributed in so short a period for the benefit of holders of nonvested shares, but the two-class method is computed as if they will be.

While we did not prepare a case involving options, we used an on-line Black-Scholes option valuation model to estimate the fair value of an option on this hypothetical stock with a \$50 strike price, 40% expected volatility, five-year expected term, 5% risk-free rate, and 2% expected dividend yield. The estimated fair value is \$17.87 per option. If the holders of the options receive dividend equivalents of \$.25 per quarter or \$1.00 per year, the estimated fair value of the option is adjusted by assuming a zero dividend yield, which increases the estimated fair value to \$21.44, or \$3.57 higher. Therefore, compensation expense for a dividend-protected option would be higher than compensation expense for an otherwise similar option without dividend protection. The two-class method applied to dividend-protected options would similarly overstate the economic impact of the dividend protection.

Summary Comments

Because the value of dividend rights is included in the estimated fair value of a share-based payment award and affects the numerator of basic eps through higher compensation charges during the vesting period, the economic impact of the dividend rights is appropriately captured under current accounting. The staff's Proposal would overstate the dilutive effect of dividend rights. We recommend that the staff terminate this project and not issue a final FSP.

We would be pleased to discuss our comments with the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours,

s/ BDO Seidman, LLP



Example of eps computations for a nonvested stock award

Assumptions:

- 1,000 shares outstanding
- Market price of \$50 per share
- Quarterly dividend of \$.25 per share, expected to and does remain constant
- Grant 100 nonvested shares on 1st day of Year 1, 5-year cliff vesting
- Risk-free interest rate 5%
- Annual net income before share-based payment, all years, \$5,000
- For simplicity:
- Expected and actual forfeitures of zero
- No income taxes
- Stock price doesn't change

Case 1: Nonvested shares do not receive dividends

Fair value of nonvested shares: \$50 less present value of expected dividends
 Present value of 20 quarterly dividends of \$.25 at 1.25% per quarter (\$4.40)
 Fair value of nonvested shares without dividend rights \$45.60
 Annual compensation expense $\$45.60/5 \times 100 = \912
 Annual net income after share-based payment = \$4,088

Basic eps, years 1 through 5
 $\$4,088/1,000 = \4.09

Diluted eps, years 1 through 5, assuming no change in stock price

Year	1	2	3	4	5
Avg unearned comp	\$4,104	\$3,192	\$2,280	\$1,368	\$456
Treasury shares	82	64	46	27	9
Incremental shares	18	36	54	73	91
Shares for diluted eps	1,018	1,036	1,054	1,073	1,091
Diluted eps	\$4.02	\$3.95	\$3.88	\$3.81	\$3.75



Basic and diluted eps, years 6 and subsequent

Annual net income=\$5,000

$\$5,000/1,100=\4.55

If the company incurs similar compensation of \$912 per year through a new award, basic eps would be $\$4,088/1,100=\3.72

Case 2: Nonvested shares receive dividends

Fair value of nonvested shares \$50

Annual compensation expense $\$50/5*100=\$1,000$

Annual net income after share-based payment=\$4,000

Basic eps, years 1 through 5, without two-class method

$\$4,000/1,000=\4.00

Basic eps, years 1 through 5, two-class method

		Common Shares	Nonvested Shares
Distributed income	\$1,100	\$1,000	\$100
Undistributed income	2,900	2,636	264
Total income	\$4,000	\$3,636	\$364
Shares		1,000	
Basic eps		\$3.64	

Diluted eps, years 1 through 5, assuming no change in stock price

The treasury stock method illustrated in Case 1 is antidilutive compared to the two-class method.

Accordingly, diluted eps would be \$3.64 for years 1 through 5

Basic and diluted eps, years 6 and subsequent \$4.55

If the company incurs similar compensation of \$1,000 per year through a new award, basic eps would be $\$4,000/1,100=\3.64