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EITF03-6A

LETTER OF COMMENT NO. 4

Director, TA&I-FSP
Financial Accounting Standards Board
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Proposed FASB Staff Position No. EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities"

We appreciate the opportunity to comment on Proposed FASB Staff Position No. EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" ("proposed FSP 03-6-a" or the "proposed FSP"). While we support the FASB's conclusion that share-based payments that provide nonforfeitable rights to dividends during the vesting period should be treated as participating securities, we are concerned that there will be considerable diversity in practice with respect to the implementation of this guidance due to the specific characteristics of nonvested share-based payments.

The proposed FSP indicates that, as required by paragraph A37 of FASB Statement No. 123 (revised 2004), *Share-Based Payment*, nonforfeitable dividends paid on awards that do not vest are recognized as additional compensation cost. Nonforfeitable dividends paid on awards that are not expected to vest are not included in the earnings allocation in computing basic earnings per share. It is unclear what the FASB intends when it states that such payments "shall not be included in the earnings allocation in computing basic EPS."[1] The question that arises is whether undistributed earnings should be allocated to the shares not expected to vest. We believe undistributed earnings should be allocated to the shares not expected to vest because until they are actually forfeited their holders are entitled to receive distributions (and in fact, for shares forfeited during the period, we believe they should be included in the two-class calculation for the period the nonvested shares were outstanding).

Another question arises when there is a change in the number of share-based payments that are not expected to vest (i.e., assumed forfeitures). For example, assume distributions were paid in the amount of $1 per share, 80 shares were expected to vest, and 20 shares were not expected to vest. In this circumstance, $80 in distributions would be recognized as a reduction to retained earnings (i.e., a dividend), while $20 would be recognized as compensation cost. Assume that the

[1] Paragraph 7 of proposed FSP 03-6-a.

company subsequently changed its assumed forfeitures so that now 90 shares are expected to vest. *Under Statement 123(R), upon the change in estimate, $10 of compensation cost* would be reversed and recorded as a dividend. The question that arises in this circumstance is how the change in the forfeiture estimate should affect the calculation of earnings per share, if at all. We think the change in estimate should not have an effect because the "dividend" is simply a reclassification that does not have an effect on earnings available to common (or participating) shareholders. However, if, contrary to our recommendation, earnings were not allocated to share-based payments expected to be forfeited, any change in estimate would raise issues about how earnings should be allocated to the securities previously expected to be forfeited that now are expected to vest or those previously expected to vest that now are expected to be forfeited (i.e., whether earnings in previous periods of that fiscal year should be reallocated in the year-to-date calculation of earnings per share).

To help address questions that we expect will arise in practice when companies apply the guidance contained in the proposed FSP, we believe that the FASB should include example calculations in the final FSP that include a forfeiture assumption as well as a change in that assumption.

Unlike dividends paid to common stockholders, dividends paid to grantees of nonvested stock often are deductible for corporate U.S. income tax purposes. A question arises whether such tax deductibility should be considered when allocating undistributed earnings under the two-class method. That is, the premise of the two-class method is that all undistributed earnings are allocated as if they were paid out in dividends, but payment of such dividends on a share-based payment in some circumstances will result in a tax benefit to the company. Should that hypothetical tax deduction be considered in the application of the two-class method? We think not as, based on the tentative conclusion of the EITF in Issue 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards*, such a tax deduction would be recognized as an increase in additional paid-in capital. However, we believe it would be useful to clarify this point by including an example in the final FSP in which dividends on share-based payments are tax deductible. It may also be advisable to delay the final issuance of the proposed FSP until the FASB ratifies any final consensus reached by the EITF on Issue 06-11.

We believe other implementation issues will arise that are not specific to share-based payments. For example, it is not clear how earnings should be allocated for the purposes of calculating diluted earnings per share when participating securities and other potentially dilutive securities are outstanding. That is, how should the dilutive effect of such securities be calculated given that if the resulting incremental shares were outstanding for the entire period presented, earnings would have been allocated between the two classes of securities differently under the two-class method.

We understand that the FASB staff has been developing example calculations that demonstrate the application of the two-class method in various circumstances including, potentially, the calculation of diluted earnings per share when participating securities (including unvested shares) and other potentially dilutive securities are outstanding for possible inclusion in a FASB Staff Position. We strongly encourage the FASB to finalize any potential guidance on the application of the two-class method prior to, or concurrent with, the issuance of proposed FSP 03-6-a to reduce the diversity in practice that likely will result from the application of the guidance in this proposed FSP.

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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