



December 19, 2006

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

Dear Mr. Smith:

The Financial Reporting Committee (the "Committee") of the Institute of Management Accountants appreciates the opportunity to provide its views to the Financial Accounting Standards Board (the "FASB") proposed FASB Staff Position ("FSP") EITF 03-6-a.

As discussed below, 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. As such, the staff's Proposal would overstate and accelerate the dilutive effect of dividend rights and accordingly we do not agree with the proposed FSP.

Specifically, 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 ("Earnings Per Share"). The proposed FSP suggests that such an award (that receives dividends) 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 and as illustrated in the attached example (Exhibit A), 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.

Should you have any questions you may contact me at 212-484-6680.

Sincerely,

A handwritten signature in black ink, appearing to read "Pascal Desroches". The signature is fluid and cursive, with a large initial "P" and "D".

Pascal Desroches

Chair, Financial Reporting Committee

Exhibit ACommentary on the Attached Example

The below example is intended to illustrate our concerns with the proposed FSP.

Assumptions:

- 1,000 shares outstanding
- Market price of \$50 per share
- Quarterly dividend of \$.25 per share
- Grant 100 nonvested shares (five year cliff vest)
- 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 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 principle that the market price of a share represents the present value of the expected cash flows to the shareholder continues to be appropriate, and a nonvested share that denies its holder expected cash flows 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 gradually 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 1: Nonvested shares do not receive dividends

Year	1	2	3	4	5
Fair value of nonvested shares	\$ 50.00				
present value of 20 quarterly dividends of \$.25	(4.40)				
Fair value of nonvested shares without dividend rights	45.60				
Annual compensation expense (\$45.60/5*100)	\$ 912.00	\$ 912.00	\$ 912.00	\$ 912.00	\$ 912.00
Annual net income after share-based payment	\$ 4,088	\$ 4,088	\$ 4,088	\$ 4,088	\$ 4,088
Basic eps, years 1 through 5 (\$4,088 / 1000 shares)	4.09	4.09	4.09	4.09	4.09
Diluted eps, years 1 through 5, assuming no change in stock price					
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

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 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.

Case 2: Nonvested shares receive dividends

<u>Year</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>
<i>Basic and Diluted eps, with two-class method</i>	Common				
	Shares				
Distributed income (\$1,100)	\$1,000				
Undistributed income (\$2,900)	2,636				
Total income (\$4,000)	\$3,636				
Shares	1,000				
Basic and Diluted eps	\$3.64	\$3.64	\$3.64	\$3.64	\$3.64

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. While the increase in fair value (and compensation expense) for a dividend protected option versus a conventional option is not quite as large as the difference between dividend protected and conventional nonvested stock, it is directionally similar. The two-class method applied to dividend-protected options would similarly overstate the economic impact of the dividend protection.