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LETTER OF COMMENT NO. 3

Mr. Lawrence Smith  
Director of Technical Application and  
Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Dear Mr. Smith:

BDO Seidman, LLP is pleased to offer comments on the FASB's Exposure Draft (ED), FSP FAS 128-a, *Computational Guidance for Computing Diluted EPS under the Two-Class Method*. Because the consensus in EITF Issue No. 03-6 expands the use of the two-class method, we support providing guidance on computing diluted eps under that method. However, we believe that the guidance in the ED is incorrect and will lead to erroneous and illogical computations of diluted eps.

The purpose of diluted eps is to present a measure of eps as if potential common shares (from exercise of options and warrants and from conversion of convertible securities, for example) with dilutive impact had been issued at the beginning of the period. The assumptions and computations should be consistent with that underlying purpose. In particular, declarations of dividends should be adjusted so that all common shares assumed to be outstanding receive the same dividends, as they legally would if the exercises or conversions had occurred. If the common shares issued upon exercise or conversion are identical to other common shares, then the directors would be compelled to declare the same dividends on all common shares; they could not discriminate against the most recently issued common shares. The proposed FSP, as we will illustrate below, makes no adjustment to distributed earnings and, as a result, effectively (and illogically) assumes that the common shares issued upon exercise or conversion receive no distributions. We considered two different approaches to correct the computation of diluted eps, both of which achieve the same result. We illustrate both in this comment letter.

We will illustrate our points using Scenario 1 from the ED. The computation in the ED, recast for illustrative purposes, is as follows:

		5,000 preferred shares	10,000 common shares	8,121 potential common shares	18,121 total common shares
Net income	\$65,000				
Interest	18,000				
Adjusted net income	\$83,000				
Distributed income	\$53,000	\$27,000	\$26,000	\$0	\$26,000
Undistributed income	30,000	4,661	13,983	11,356	25,339
Total income	\$83,000	\$31,661	\$39,983	\$11,356	\$51,339
Shares			10,000	8,121	18,121
Diluted eps			\$4.00	\$1.39	\$2.83

Note that the \$2.83 diluted eps in the ED represents the sum of \$26,000 distributed to the 10,000 outstanding common shares plus \$25,339 of undistributed income allocated to 18,121 common shares (representing the outstanding common shares plus the common shares assumed issued from exercise of options and conversion of convertible debt) divided by 18,121 shares. The computation assumes that a \$2.60 dividend is declared only on the 10,000 outstanding common shares, and not on the 8,121 common shares that would have been outstanding if the options had been exercised and the convertible debt had been converted at the beginning of the year. This is not a faithful representation of how earnings would have been distributed if the exercises and conversion had occurred at the beginning of the year.

One appropriate approach is to compute diluted eps assuming that the company would have declared the same \$2.60 dividend on each of the 18,121 common shares, and the same \$5.40 dividend on each of the preferred shares. That computation would be as follows:

		5,000 preferred shares	10,000 common shares	8,121 potential common shares	18,121 total common shares
Distributed income	\$74,115	\$27,000	\$26,000	\$21,115	\$47,115
Undistributed income	8,885	1,380	4,141	3,364	7,505
Total income	\$83,000	\$28,380	\$30,141	\$24,479	\$54,620
Shares			10,000	8,121	18,121
Diluted eps			\$3.01	\$3.01	\$3.01

In a situation involving high distributions and large numbers of potential common shares, it is possible that distributed income could exceed net income. In this situation, the “overdistributed” income would be allocated to the classes of shares based on their terms. We believe that ordinarily such “overdistributed” income would be allocated to common shares.

The alternative approach would hold the \$53,000 of distributions constant, but reallocate the distributions as if 18,121 common shares had been outstanding. In this situation, after declaring the required \$25,000 distribution on the preferred shares, there would be \$28,000 to distribute to the 18,121 common shares at a rate of about \$1.545 per share. Thus, the participation right of the preferred shares would not have been triggered. Then, the \$30,000 of undistributed income would be allocated to the two classes based on their respective rights. An additional \$.455 per share would be distributable to the common shares before the participating rights of the preferred shares would be triggered. Other than a minor \$1 rounding difference, the results are identical to the first approach. We believe both approaches would yield the same results in substantially all circumstances.

		5,000 preferred shares	10,000 common shares	8,121 potential common shares	18,121 total common shares
Distributed income	\$53,000	\$25,000	\$15,452	\$12,548	\$28,000
Undistributed income	30,000	3,381	14,689	11,930	26,619
Total income	\$83,000	\$28,381	\$30,141	\$24,478	\$54,619
Shares			10,000	8,121	18,121
Diluted eps			\$3.01	\$3.01	\$3.01

The first approach retains the actual declared dividends per share but changes the total dollars of distributed income. The second approach retains the total dollars of distributed income but changes the per share dividends. We have different opinions internally about which approach is more understandable. Both approaches illustrate that the approach in the ED is flawed and understates diluted eps.

#### Editorial Comment

Paragraph 4 of the ED outlines a three-step approach to computing diluted eps. Step 2 contains approaches (a) and (b). It was not clear to us how the illustrations followed Steps 2 (a) and (b). We think it would be helpful for the illustrations to label each step to match the narrative.

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

Very truly yours,  
s/ BDO Seidman, LLP