

COMMENT LETTER ANALYSIS

ON FASB EXPOSURE DRAFT, *EARNINGS PER SHARE*

In December 2003, the Board issued an Exposure Draft of a proposed Statement, *Earnings per Share*, and invited comments by April 13, 2004. To date, 28 letters have been received. This memo summarizes and analyzes respondent comments.

INDIVIDUAL ISSUE ANALYSIS

Issue 1: Replacement of Paragraph 46—Incremental Shares in Diluted EPS

General Comments

The Exposure Draft proposes that the number of incremental shares included in quarterly and year-to-date diluted EPS be computed using the average market price of common shares for the quarterly and year-to-date periods, respectively.

Based upon the comments received and the statistics presented in Appendix A, a majority of respondents agreed with the Board. Respondents generally agreed with the Board's decision on the basis that it would simplify the calculation and eliminate a difference between US GAAP and IFRS and also because they believe that the frequency of interim reporting should not affect the calculation.

Emerson, in comment letter No. 18, disagreed with this change, stating that:

Since stock prices are generally more volatile than earnings, the proposed changes will lead to even greater differences between quarterly and annual EPS amounts. We question the theoretical support for reflecting subsequent events (i.e. changes in stock prices), in EPS by effectively recomputing previous quarters' EPS in the annual computation. Obviously, EPS is an important measure that is emphasized by the investment community, and we believe the proposed change will have detrimental ramifications. Given the complexities that already exist surrounding the application of FAS 128 and the communication problems incurred when it was adopted, we do not see why the EPS computation should be changed again. Any perceived benefits of convergence do not merit the deterioration of US GAAP.

Suggestions for Improvement

One respondent suggested that Statement 128 could be further improved by requiring disclosure of the difference between the sum of the quarterly amounts used in the denominator and the amount used in the denominator for the year-end calculation. In addition, he suggested the final standard require an explanation concerning the impact of share transactions on the weighting of shares entering into the computation.

A number of respondents pointed out a discrepancy between Statement 128 and IAS 33 concerning contingently issuable shares that are included in the year-to-date diluted EPS computation. Both standards require that contingently issuable shares be included in the quarterly computation of diluted EPS as of the beginning of the period in which the contingency is satisfied. However, for the year-to-date diluted EPS calculation, the Statements differ in that Statement 128 requires that the contingently issuable shares be included on a weighted-average basis, while IAS 33 requires that they be included from the beginning of the period, or the date of the contingent share arrangement if later, if the conditions for issuance are satisfied by the balance sheet date. Those respondents agreed that the final statement should converge with the treatment required by IAS 33, (i.e., amend Illustration 3 in paragraph 152, including the “Note” of Appendix C.)

Issue 2: Elimination of the Rebuttable Presumption in Paragraph 29

The Exposure Draft proposes deleting the last sentence of paragraph 29, which allows issuing entities to overcome the presumption that certain contracts that may be settled in cash or shares will be settled in shares. If the Board finalizes that proposal as presented in the Exposure Draft, entities would be required to assume that all such contracts will be settled in shares (if dilutive) and that those shares will be included in the calculation of basic EPS.

Respondents’ comments on the amendment to paragraph 29 were varied. Those that were in favor of the amendment cited convergence with IAS 33, simplification of the requirements, and more consistent application among entities as reasons for their support. Comment letter No. 23, from Deloitte & Touche, is representative of the view held by three of the four major accounting firms: “[w]e believe that [the] amendment is consistent

with the objective of diluted EPS which is to give effect to all dilutive potential common shares.”

Several respondents suggested a modification to the transition provisions of the proposed Statement. For instance, Ernst and Young, in comment letter No. 2, stated:

We suggest that the FASB modify the transition for instruments that can be settled in cash or shares at the issuer’s option such that the new standard need not be applied retroactively in all circumstances. Specifically, we believe that if the instrument is no longer outstanding on the adoption date, or if the instrument has been modified prior to the adoption date to require cash settlement of the feature that previously permitted cash or share settlement at the issuer’s option, the instrument should be excluded from the retroactive application of the new standard. We believe that this approach would provide a more equitable result for those companies that paid a premium for what is essentially a purchased put option (the ability to sell shares for the cash necessary to satisfy the investor’s put option) that now would result in a rather onerous earnings per share impact under the Proposed Amendment.

Another respondent recommended that the final Statement provide guidance regarding the disclosure of transactions that are settled in cash subsequent to the reporting period but prior to the issuance of the financial statements.

One constituent, while agreeing with the modification proposed above, also offered an alternative solution. They suggested the final standard include a stipulation that if, upon adoption of the Statement, new information is available regarding the final settlement of an instrument, that information should be taken into account in the retrospective adoption and restatement of financial statement information.

Respondents who disagreed with the Board’s proposal generally cited two reasons as a basis for their disagreement. First, some respondents viewed the amendment as a “bright line rule” and felt that the Board should avoid bright lines in favor of more objectives-based or principles-based accounting, in accordance with the SEC’s 2003 report entitled *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*. Second, several respondents disagreed because they believe the revised requirement does not reflect the true economics of the contract in instances where the issuer intends to settle the contract in cash.

Issue 3: Inclusion of Mandatorily Convertible Securities in the Basic EPS Calculation

The Exposure Draft proposed that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of shares outstanding used in computing basic EPS from the date that conversion becomes mandatory using the if-converted method.

Some respondents agreed with the proposed guidance conceptually but had a number of recommendations for improvement. Those recommendations largely fell into three categories: 1) defining the term mandatorily convertible security; 2) establishing, or more clearly communicating, the principle behind the proposed requirement; and 3) clarification of the appropriate accounting when the mandatorily convertible securities would be antidilutive.

Definition of a Mandatorily Convertible Security

Many respondents recommended that the final Statement define *mandatorily convertible security*. Those respondents point out that there are many financial instruments and packages of financial instruments that financial market participants broadly refer to as “mandatorily convertible securities.” Comment letter No. 2, from E&Y, provides several good examples of different types of mandatorily convertible securities.

PwC suggests the definition of a mandatorily convertible security should be “one that will be converted into a fixed number of common shares at a fixed future date when all contingencies have been resolved and the number of conversion shares is known.” They argue that otherwise, the definition will be inconsistent with the notion that basic EPS includes only shares that are no longer subject to contingencies. Other respondents also recommend including language in paragraph 2(a) explicitly stating that shares to be issued upon conversion of a mandatorily convertible security should be included in the basic EPS calculation from the date the security becomes mandatorily convertible. They believe this language is necessary to clarify the Statement’s requirements and to promote consistency in application.

A number of respondents inquired as to whether the Board intended for instruments that mandatorily convert into a variable, rather than a fixed, number of shares to be included in the basic EPS calculation. Respondents named a variety of other issues that will have to be addressed if the Board had intended for mandatorily convertible securities that convert into a variable number of shares to be included in the basic EPS calculation.¹

Some respondents recommended that the final Statement provide implementation guidance for computing the number of shares determined under the if-converted method for instruments whose features change over the contract period (for example, a conversion ratio based on a formula that includes the conversion date share price.)

Principle Behind Requirement

A number of respondents requested that the final Statement explain the principle behind the proposed requirement. They argue that the standard should articulate the principle so that it can be applied to an ever-evolving variety of financial instruments.

For example, E&Y commented that “[w]e believe it is important for the FASB to explain the principle used as a basis for their conclusion so that preparers can apply that principle to evolving financial instruments.” Deloitte expressed a similar view.

Anti-dilution

A majority of respondents commented that there are situations where the inclusion of mandatorily convertible shares in the basic EPS calculation will be antidilutive. Several believe it is inappropriate to include the effects of such securities if the effects were antidilutive while others simply questioned what the appropriate accounting would be in those situations. A number of respondents requested that if the Board’s intention was to require including the effects of mandatorily convertible securities even if the effect was antidilutive, the final standard include examples of those circumstances.

¹ The other technical issues that arise under instruments that mandatorily convert into a variable number of shares raised by respondents are not detailed in this memo because the staff believes that the Board clearly intended to include only securities that are mandatorily convertible into a fixed number of shares at a fixed future date. While the proposed Statement is not clear on this point, the minutes of the October 15, 2003 Board meeting are clear.

Respondents Who Disagree

A number of respondents believe that the notion of dilution should not be introduced in the computation of basic EPS. D&T argues that to include mandatorily convertible securities in the computation of basic EPS “further blurs the already somewhat confusing line between basic and diluted EPS” and that despite their support for international convergence, they do not believe the new provisions are an improvement over current guidance. Other constituents argue that mandatorily convertible preferred shares do not meet the intent of paragraph 10 of Statement 128 because that current provision requires only those shares that are no longer subject to contingencies to be used in the computation of basic EPS.

Additionally, some constituents argue that including mandatorily convertible securities in basic EPS is not representationally faithful to the underlying economic substance during the period in which the mandatorily convertible securities are outstanding and not yet converted.

EITF Issue 03-6

Two respondents believe that convertible participating securities should be included in the computation of basic EPS using the two-class method described in EITF Issue 03-6, “Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings per Share”.

Transition

A number of respondents commented on the retrospective application in the proposed Statement. While several agreed with the transition requirements as proposed, more respondents are concerned that retrospective application unfairly penalizes companies that structured convertible securities prior to the proposed provisions and causes confusion among financial statement users. Further, one respondent argues that the period they refer to as the “prior accounting principle hangover” will be relatively short because the majority of convertible debt securities have net share settlement features, which have historically caused a high rate of settlement in the early years of the contract. Another respondent argues that a requirement to restate prior year financial statements

adds internal costs to recalculate, external auditing costs, and the cost of explaining the restatement to investment analysts and the public. Further, several respondents argued that “restatement” has a negative connotation in today’s accounting environment that will result in confusion and frustration on the part of financial statement users.