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**Proposed Statement of Financial Accounting Standards,  
*Earnings per Share, an amendment of FASB Statement No. 128*  
File Reference No. 1200-200**

Dear Ms. Bielstein:

Ernst & Young appreciates the opportunity to respond to the FASB's Proposed Statement of Financial Accounting Standards, *Earnings per Share, an amendment of FASB Statement No. 128* (the "Proposed Amendment"). We are supportive of the efforts of the FASB and the International Accounting Standards Board to harmonize their accounting standards and encourage both Boards to continue their efforts in this regard. While we are supportive of certain aspects of the Proposed Amendment, we do have certain concerns about the proposal that are described further below.

**Treasury Stock Calculation for Annual and Year-to-date Periods**

We agree with the proposed amendment to paragraph 46 of FASB Statement No. 128, *Earnings per Share*, regarding the change in the application of the treasury stock method when computing annual and year-to-date diluted earnings per share.

**Instruments That May Be Settled in Stock or Cash**

The FASB has proposed that if a financial instrument may be settled in cash or shares at the issuer's option, share settlement must be assumed for purposes of calculating diluted earnings per share. The FASB's proposal clearly has the benefits of simplicity, consistency in application, and convergence with International Accounting Standards (IAS). However, we are concerned that because of the proposed transition requirements, application of the proposed change would have a rather dramatic and somewhat punitive impact on companies that have issued certain types of instruments in the past. For example, we frequently see circumstances in

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which an issuer can satisfy the exercise of an investor's put option embedded in a convertible debt instrument by delivering (a) cash in the amount of the stated put price or (b) the issuer's shares with a value equal to the put price. While most issuers intend to satisfy any put of the convertible debt instrument in cash, the added flexibility of being allowed to deliver shares in the event of severe constraints on the issuer's liquidity has value to the issuer. Essentially, the issuer paid a premium for an option to satisfy the put price in shares. The FASB's proposal would require those issuers to calculate diluted earnings per share assuming the instrument was put and include the number of shares necessary to satisfy the forward price (based on the company's prevailing stock price) in the calculation of diluted earnings per share using the if-converted method. The resulting dilution often would be much greater than that which would result from calculating the dilutive impact of the instrument using the stated conversion price. When coupled with the retroactive transition proposed by the FASB, the proposal would have a dramatic impact on the historical earnings per share of issuers of these types of instruments.

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.

#### **Mandatorily Convertible Securities**

In connection with the FASB's proposal to require that the shares underlying a mandatorily convertible security be included in the denominator of basic earnings per share calculation, we are concerned that the Board has used the term "mandatorily convertible security" without a clear definition of that term or a discussion of the principle behind the new rule. There are many financial instruments (or packages of financial instruments) that financial market participants broadly characterize as "mandatorily convertible." For example:

1. Debt or preferred stock that is required to be converted into a fixed or variable number of common shares upon a specified date or an event certain to occur.
2. A prepaid forward sale contract, which is economically equivalent to the mandatorily convertible instrument described under Item (1) (i.e., the issuer has received cash and will be required to deliver shares in the future).

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3. Certain unit structures, which generally include a debt security (or mandatorily redeemable preferred shares) and a detachable forward sale contract for a fixed or variable number of shares. In some circumstances, the forward sale price may be settled by tendering the debt instrument.

Additionally, while not commonly seen in practice, a mandatorily convertible security could be substantially replicated by writing a deep in-the-money call option on the company's shares (say, with a nominal strike price).

Without further guidance, many might conclude that the impact of the proposed amendment is limited to debt or preferred stock that is required to be converted into a fixed or variable number of common shares upon a specified date or an event certain to occur. We 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. For example, is the principle underlying the change that the shares must be issued under the forward (i.e., there is no optionality) and, therefore, the shares must be included in the denominator of basic earnings per share? If so, then this conclusion also would appear to apply to traditional forward contracts. Is the principle that the share purchase price already has been paid and, therefore, the shares must be delivered in the future without any further proceeds? If so, the instruments described in (1) and (2), and perhaps (3), would be subject to this guidance. Finally, does the answer change if the number of shares to be delivered under the forward or convertible instrument is fixed or variable? We believe that the proposed mandatorily convertible share guidance should apply to any contracts under which shares must be delivered in the future without any further substantive consideration (based on the number of shares that would be delivered if the balance sheet date were the delivery date).

We also suggest that the FASB clarify how this new requirement should be applied when the impact of including the shares underlying the mandatorily convertible instrument in basic earnings per share is antidilutive. We observe that the similar instruments addressed in paragraph 10 of Statement 128 are always included in the denominator of the basic earnings per share calculation. It could be argued that because the shares underlying a mandatorily convertible instrument must be issued, the shares should be included in the denominator of the earnings per share calculation using the if-converted method, even if antidilutive. We assume that was not the FASB's intent. If we are correct in our assumption, the FASB should consider including in paragraph 2.a. of the Proposed Amendment a reference to paragraph 27 of Statement 128 to clarify that the if-converted method should not be applied if its impact is antidilutive. If our assumption is not correct, the FASB should consider clarifying its intent in paragraph 2.a. of the Proposed Amendment that the "if-converted" approach should be used to determine the number of shares to add to the denominator of basic and diluted earnings per share even if antidilutive (of course, under that approach, interest on mandatorily convertible instruments would never impact earnings per share).

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### Contingently Issuable Shares

An inconsistency presently exists between Statement 128 and IAS 33, *Earnings Per Share*, with respect to the manner that contingently issuable shares are included in the year-to-date diluted earnings per share computation. Both Statement 128 and IAS 33 require that contingently issuable shares be included in the quarterly computation of diluted earnings per share as of the beginning of the period in which the contingency is satisfied (or the date of the contingent share agreement, if later). For the year-to-date computation of diluted earnings per share, Statement 128 requires that the contingently issuable shares be included on a weighted-average basis. However, IAS 33 requires that the contingently issuable shares be included from the beginning of the period, or the date of the contingent share arrangement, if later, if the conditions for issuance would have been satisfied had the balance sheet date been the end of the contingency period. We believe that the Proposed Amendment should amend footnote 18 and Illustration 3 of Statement 128 to converge the accounting treatment for contingently issuable shares with that required under IAS 33. We see no conceptual basis for the different accounting treatment between the quarterly and year-to-date computation of diluted earnings per share as presently required by Statement 128. The FASB apparently shares that view, which resulted in its proposed amendment to Statement 128 with respect to the calculation of the dilutive effect of instruments using the treasury stock method.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

