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Ms. Suzanne Bielstein  
Director of Major Projects and Technical Activities  
File Reference No. 1240-001  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856

Dear Ms. Bielstein:

BDO Seidman, LLP is pleased to provide comments on the FASB's proposed Statement, *Earnings per Share*.

#### Overall Comments

We generally agree with the proposed changes to earnings per share (EPS) computations. With respect to liabilities that are potentially settleable in shares, we agree that the liability extinguishment should be treated as proceeds in the treasury stock method, but we believe the liability measurement should be consistent with the average share price used in the treasury stock method.

We continue to disagree with the proposed change for mandatorily convertible instruments.

#### Comments on the Issues in Notice for Recipients

Issue 1. *This proposed Statement would require that in applying the treasury stock method to an instrument classified as a liability but potentially settled in shares, the carrying amount of an extinguished liability upon issuance of the shares should be included as assumed proceeds in the computation of incremental shares. Do you agree? If not, why? This provision would apply only to instruments subject to the treasury stock method and would not affect the EPS computation for instruments that are accounted for using the if-converted method under Statement 128. Do you agree? If not, why?*

We agree that in applying the treasury stock method, extinguishment of a liability is a form of proceeds and should be treated as such.



We agree that this provision should apply only to instruments subject to the treasury stock method, and that the Board should not expand the use of the treasury stock method to instruments currently subject to the if-converted method.

*Issue 2: This proposed Statement would require that the amount of the extinguished liability to be included in assumed proceeds be measured at the carrying amount as of the end of the period for which EPS is being measured. This measurement would lead to dilution when the share price used to compute the end-of-period liability is lower than the average share price used in the treasury stock method. An alternative approach would be to measure the liability used in the assumed proceeds computation at the value at which the liability would have been recorded at the end of the period had the end of the period share price been equal to the average share price during the period. Under that alternative, an instrument subject to the treasury stock method that is classified as a liability and carried at fair value would never be dilutive. Do you agree with the measurement objective in the proposed Statement? Why or why not? If not, would you favor the alternative measurement objective? Why or why not?*

We support the alternative approach of measuring the proceeds from extinguishment using the average share price. A liability linked to a company's share price and measured at fair value does not create any economic dilution. The dilution created under the proposed method when the end-of-period share price is lower than the average share price seems to us artificial and representationally unfaithful.

#### Mandatorily Convertible Instruments

We continue to disagree with the Board's conclusion about mandatorily convertible instruments. We hope the Board will not consider us argumentative for expanding on the concerns that we expressed in our comment letter on the 2003 Exposure Draft.

The form of mandatorily convertible instrument that we see most frequently in the U.S. is mandatorily convertible preferred stock. Typically, the preferred stock is outstanding and receives cash dividends for about three years, and then converts to common shares. The proposed add back of the cash dividends and addition of the as-if-converted common shares to the denominator is almost always anti-dilutive. We continue to believe that an EPS computation that excludes (adds back) the actual cash dividends paid to the preferred shareholders during the three-year period is not a faithful reflection of the economic cost of the preferred dividends to the common shareholders. Perhaps the Board feels that the proposed computation is a better predictor of future EPS after the mandatory conversion occurs, and that reducing EPS for the actual cash dividends for three years isn't meaningful. Would the Board feel the same if the mandatorily convertible preferred stock has a 50- or 100-year life? That is, would the Board be comfortable with EPS that excludes (adds back) cash dividends paid to preferred stockholders for 50 or 100 years? We understand that the cash dividends to preferred shareholders will be reflected in the statement of shareholders' equity and, if sufficiently



large, displayed on the income statement. EPS is an important metric, however, and we do not believe that excluding actual cash dividends paid to preferred shareholders provides a meaningful measure.

The Board may think that a 100-year mandatorily convertible preferred is far fetched, but it may not be. Suppose that a company could issue 6% perpetual preferred stock for its stated value of \$1,000 per share. The fair value of the first 100 years' dividends is \$997. If the company issues perpetual preferred stock, income available to common shareholders is reduced by \$60 for each preferred share issued. If instead the company issues 6% preferred stock that is mandatorily convertible into 10 common shares at the end of 100 years, for \$997 per share, the Board proposes that income available to common stockholders would not be reduced and that shares outstanding for EPS purposes would increase by 10 common shares for each preferred share issued. If the company's EPS currently is less than \$6.00 per share, the mandatorily convertible preferred will be less dilutive than the perpetual preferred. A company might be willing to forgo proceeds of \$3 in exchange for less reported EPS dilution. Because the common shares issuable upon conversion are issuable 100 years in the future, investors might be relatively indifferent to how many common shares they will receive. If only one share of common stock is issuable upon mandatory conversion instead of 10 shares, the issuer would report negligible EPS dilution from preferred stock that pays a substantive cash dividend for 100 years.

Suppose the mandatorily convertible security is a participating security, for example, a second class of common stock or a participating preferred stock, that mandatorily converts to ordinary common stock at a stated future date. It is not clear to us which provisions of Statement 128 would take precedence. If the participating nature of the securities takes precedence, the issuer would use the two-class method to compute basic EPS. If the mandatorily convertible nature of the securities takes precedence, the issuer would use the if-converted method to compute basic EPS. We believe the two-class method should be used, but the Board should clarify its intent in the final Statement.

It appears to us that the proposed treatment of mandatorily convertible securities may create opportunities to compensate employees without commensurate EPS charges. For example, a company could issue debt securities to executives with contingent interest features, such that the interest effectively represents bonuses. If the debt securities are mandatorily convertible to a fixed number of common shares upon separation from service (an event that is certain to occur), the interest would be charged to expense but would be added back in computing EPS. Similarly, a company could issue debt securities to retirees with interest that is indexed to health insurance premiums. If the debt securities are mandatorily convertible to a fixed number of common shares upon death (another certain event), the interest would be charged to expense but would be added back in computing EPS.



In the 1990s, certain European companies issued very long-lived (for example, 100 years) debt securities that required interest payments for about 15 years, no interest payments for the remaining 85 years, and repayment of principal at the end of 100 years. Suppose instead of a cash principal payment at the end of 100 years, the debt security mandatorily converts into a small, fixed number of common shares at the end of 100 years. Interest would be charged to expense but would be added back in computing EPS.

We have attempted in the preceding paragraphs to provide examples of instruments for which the Board's proposed EPS approach is troublesome to us. We have no doubt that those who earn a living from developing innovative securities will be far more creative than we are. We believe the approach that (1) provides the most meaningful EPS and (2) is less sensitive to changes in the terms of financial instruments is to treat mandatorily convertible instruments the same as traditional optionally convertible instruments—include interest or dividends in the numerator for basic EPS and use the if-converted method, if dilutive, for diluted EPS. This approach reflects the economic cost of the dividends or interest in basic EPS and any dilution from conversion in diluted EPS.

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

Very truly yours,

s/ BDO Seidman, LLP