

EITF ABSTRACTS

Issue No. 04-8

Title: The Effect of Contingently Convertible Instruments on Diluted Earnings per Share

Dates Discussed: June 30–July 1, 2004; September 29–30, 2004; November 17–18, 2004

References: FASB Statement No. 128, *Earnings per Share*
FASB Statement No. 129, *Disclosure of Information about Capital Structure*
FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
FASB Staff Position FAS 129-1, "Disclosure Requirements under FASB Statement No. 129 Relating to Contingently Convertible Securities"
Proposed FASB Statement, *Earnings per Share* (a revision of Statement 128) (December 2004)

ISSUE

1. This Issue addresses when contingently convertible instruments should be included in diluted earnings per share. For purposes of this Issue, contingently convertible instruments are instruments that have embedded conversion features that are contingently convertible or exercisable based on (a) a market price trigger or (b) multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition. A market price trigger is a market condition that is based at least in part on the issuer's own share price. Examples of contingently convertible instruments subject to this Issue include contingently convertible debt, contingently convertible preferred stock, and Instrument C in Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion," all with embedded market price triggers.

2. While the terms of contingently convertible instruments vary, a typical instrument includes a market price trigger that exceeds a specified conversion price of the issuer's underlying stock price on the date of issuance by a specified percentage (for example, 10 percent, 20 percent, or 30 percent). Some contingently convertible instruments have floating market price triggers for which conversion is dependent upon the market price of the issuer's stock exceeding the conversion price by a specified percentage(s) at specified times during the term of the debt. Other contingently convertible instruments require that the market price of the issuer's stock exceed a specified level for a specified period (for example, 20 percent above the conversion price for a 30-day period). In addition, contingently convertible instruments may have additional features such as parity features, issuer call options, and investor put options.

3. The issue is when the dilutive effect of contingently convertible instruments should be included in diluted earnings per share computations.

EITF DISCUSSION

4. The Task Force reached a consensus that contingently convertible instruments should be included in diluted earnings per share (if dilutive) regardless of whether the market price trigger has been met. The Task Force observed that there is no substantive economic difference between contingently convertible instruments and conventional convertible instruments with a market price conversion premium. Accordingly, the Task Force concluded that the treatment for diluted EPS should not differ because of a contingent market price trigger.

5. The Task Force also agreed that the consensus should be applied to instruments that have multiple contingencies if one of the contingencies is a market price trigger and the instrument is convertible or settleable in shares based on meeting a market condition—that is, the conversion is not dependent (or no longer dependent) on a substantive non-market-based contingency. For example, if an instrument is convertible upon meeting a market price trigger *or* a substantive non-market-based contingency (for example, a change in control), the issuer should apply the consensus in this Issue. Alternatively, if the instrument is convertible upon achieving both a market price trigger *and* a substantive non-market-based contingency, the instrument is not within the scope of this Issue until the non-market-based contingency has been met.

6. At the November 17–18, 2004 meeting, the Task Force discussed the effective date of the consensus in this Issue. The consensus would have been applied to reporting periods ending after the effective date of the proposed Statement that amends Statement 128, which was expected to be December 15, 2004. The FASB staff indicated that it now expects that the proposed Statement will be issued in the first quarter of 2005, and its effective date will need to be deliberated at a future Board meeting. The Task Force agreed to change the transition provisions of the consensus to require that the guidance in this Issue be applied to reporting periods ending after December 15, 2004.

Transition

7. The consensus should be applied to reporting periods ending after December 15, 2004.

8. For contingently convertible instruments outstanding at the date of adoption of this consensus¹ and whose terms have not been modified since the date of issuance, prior-period diluted earnings per share should be restated to conform to the guidance in this consensus for comparative purposes.

9. For contingently convertible instruments outstanding at the date of adoption of this consensus and whose terms have been modified, prior-period diluted earnings per share should be restated to conform to the guidance in this consensus for comparative purposes based on the modified terms of the instrument at the date of adoption of this Issue.

10. For contingently convertible instruments that have been stock settled (stock settled would include conversion) prior to the date of adoption of this consensus, all prior-period diluted earnings per share should be restated to conform to the guidance in this consensus for comparative purposes.

11. Contingently convertible instruments that have been cash settled prior to the date of adoption of this consensus are not subject to the guidance in this consensus, and prior-period diluted earnings per share should not be restated.

Board Ratification

12. At its October 13, 2004 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

¹The date of adoption of this consensus is the end of the first reporting period after its effective date.

13. At its November 30, 2004 meeting, the Board ratified the change to the effective date for the guidance in this Issue.

STATUS

14. The EITF Agenda Committee will consider whether the Task Force should address (a) the effect on EPS of non-market-based contingencies for issued instruments and (b) market-based contingencies for freestanding instruments.

15. No further EITF discussion is planned.

Exhibit 04-8A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS IN ISSUE 04-8

The following illustrate diluted earnings per share computations for two examples of contingently convertible instruments.

Example 1—Contingently convertible debt with a market price trigger

The holder of the debt may convert the debt into shares of common stock when the share price exceeds the market price trigger; otherwise, the holder is only entitled to the par value of the debt.

Assumptions:

1. Principal amount of the convertible debt—\$1,000
2. Conversion ratio—20
3. Conversion price per share of common stock—\$50²
4. Share price of common stock at issuance—\$40
5. Market price trigger—average share price for the year must exceed \$65 (130% of conversion price)
6. Interest rate—4%
7. Effective tax rate—35%
8. Shares of common stock outstanding—2,000.

The contingently convertible debt is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X, is \$10,000, and the average share price for the year is \$55. The issuer of the contingently convertible debt should apply the consensus in this Issue, which requires the issuer to include the dilutive effect of the convertible debt in diluted earnings per share even though the market price

²Conversion price = (Convertible bond's principal amount) ÷ (Conversion ratio) = \$1,000 ÷ 20 = \$50.

trigger of \$65 has not been met. In this example, basic EPS is \$5.00,³ and applying the if-converted method to the debt instrument dilutes earnings per share to \$4.96.⁴

Example 2—Instrument C in Issue 90-19 with a market price trigger

In Example 2, the assumptions are the same as Example 1 except that the issuer of the contingently convertible debt must settle the principal amount of the debt in cash and it may settle any conversion premium in either cash or stock. The holder of the instrument is only entitled to the conversion premium if the share price exceeds the market price trigger. The contingently convertible instrument is issued on January 1, 200X, income available to common shareholders for the year ended December 31, 200X is \$10,000, and the average share price for the year is \$64. In this example, basic EPS is \$5.00, and applying the method required by Issue 90-19 for this instrument results in diluted earnings per share of \$4.99.⁵

³Basic EPS = [Income available to common shareholders (IACS)] ÷ [Shares outstanding (SO)] = \$10,000 ÷ 2,000 shares = \$5.00 per share.

⁴Diluted EPS computed using the if-converted method = [IACS + Interest (1-tax rate)] ÷ (SO + Potential common shares) = (\$10,000 + \$26) ÷ (2,000 + 20) shares = \$4.96 per share.

⁵Potential common shares = (Conversion spread value) ÷ (Average share price) = \$14 × 20 shares ÷ \$64 = 4.38 shares.

Diluted EPS (computed in accordance with Issue 90-19) = IACS ÷ (SO + Potential common shares) = (\$10,000) ÷ (2,000 + 4.38) shares = \$4.99 per share.