

PROPOSED FASB STAFF POSITION

No. EITF 03-6-a

Title: Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities

Comment Deadline: December 19, 2006

Introduction

1. This FASB Staff Position (FSP) addresses whether instruments granted in share-based payment transactions may be participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing basic earnings per share (EPS) pursuant to the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, *Earnings per Share*.

Background

2. Statement 128 defines EPS as “the amount of earnings attributable to each share of common stock,” and indicates that the objective of EPS is to measure the performance of an entity over the reporting period. In its deliberations of Statement 128, the Board decided to require the use of the two-class method of computing EPS for those enterprises with participating securities or multiple classes of common stock (each with a different dividend rate from those of the other classes of common stock). Paragraph 60(a) of Statement 128 describes participating securities as follows:

Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share)

3. The Emerging Issues Task Force (EITF) considered participating securities in Issue No. 03-6, “Participating Securities and the Two-Class Method under FASB Statement No. 128.” In Issue 2 of Issue 03-6, the Task Force reached a consensus that a participating security is a security that may participate in undistributed earnings with common stock in its current form, whether that participation is conditioned upon the occurrence of a specified event or not. Issue

03-6 provides guidance on share-based payment awards that contain a right to receive dividends declared on the common stock of the issuer that are fully vested. However, in Issue 2(a) the Task Force stopped short of providing guidance on share-based payment awards until such time as those awards are fully vested.

4. At the September 29 and 30, 2004 EITF meetings, the Task Force confirmed that Issue 03-6 does not provide guidance about whether unvested instruments that are granted as share-based compensation are participating securities. As a result, Issue No. 04-12, “Determining Whether Equity-Based Compensation Awards Are Participating Securities,” was added to the EITF’s agenda. At the November 17 and 18, 2004 EITF meetings, the Task Force discussed Issue 04-12. At that meeting, the Task Force was unable to reach a consensus; accordingly, the Task Force agreed to discontinue discussion of Issue 04-12 and to remove it from the EITF’s agenda.

FASB Staff Position

Rights to Receive Unpaid Dividends or Dividend Equivalents on Unvested Share-Based Payment Awards

5. Rights to dividends or dividend equivalents (whether paid or unpaid) on unvested share-based payment awards that would provide a noncontingent transfer of value to the holder of the share-based payment award constitute participation rights and therefore should be included in the computation of basic EPS pursuant to the two-class method. A share-based payment award that contains a nonforfeitable right to receive cash when dividends are paid to common shareholders irrespective of whether that award ultimately vests or remains unvested shall be considered a participating security. That is, the holder of a share-based payment award receives a noncontingent transfer of value each time an entity declares a cash dividend during the contractual period of the share-based payment award. Because the transfer of value is not contingent on whether the holder provides any additional services after the date of dividend declaration, the share-based payment award should be considered a participating security. In contrast, the right to receive cash dividends that the holder will forfeit if the award does not vest does not constitute a participation right.

6. A share-based payment award that participates in undistributed earnings via a reduction in the exercise price of the award when distributions are made to common shareholders would not be considered a participation right because the transfer of value to the holder of the award is contingent upon the exercise of the award. That is, a participation right in the form of a reduction in the exercise price of a share-based payment award is a contingent transfer of value to the holder of a share-based payment award. This conclusion is consistent with the Task Force's consensus in Issue 2(b)(i) of Issue 03-6 "that dividends or dividend equivalents transferred to the holder of a convertible security in the form of a reduction to the conversion price or an increase in the conversion ratio of the security do not represent participation rights."

Dividend or Dividend Equivalents Paid on Unvested Shares-Based Payment Awards

7. Paragraph A37 of FASB Statement No. 123 (revised 2004), *Share-Based Payment*, requires that nonrefundable dividends or dividend equivalents paid on awards that do not vest be recognized as additional compensation cost and that dividends or dividend equivalents paid on awards that do vest be charged to retained earnings. Therefore, dividends or dividend equivalents that are actually paid and are accounted for as compensation cost because the unvested share-based payment award is not expected to vest (or does not vest) shall not be included in the earnings allocation in computing basic EPS. To do so would include the dividend as both (a) a reduction of earnings available to common shareholders (compensation cost) and (b) a reduction of earnings available to common shareholders (distributed earnings).

Effective Date and Transition

8. The provisions of this FSP shall be applied in the first reporting period beginning after the date the FSP is posted to the FASB website. All prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of this FSP.