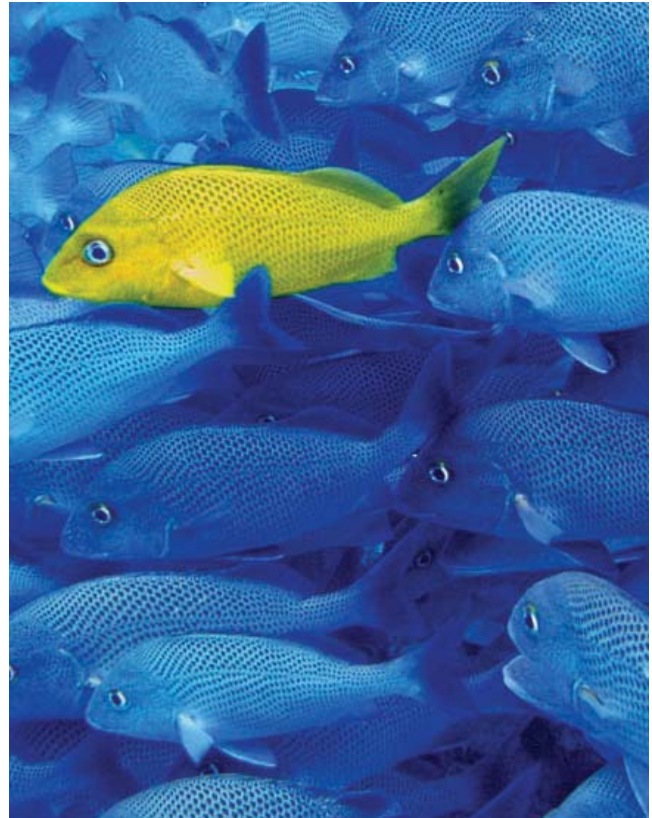


defining issues[®]

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ALERT

“Participating Securities” for EPS Calculations

Some companies that issue securities that are entitled to participate in dividends with common stocks will report lower earnings per share under a new Consensus by the Emerging Issues Task Force than under previous requirements.¹ The Consensus clarifies what is meant by a “participating security,” provides guidance on applying the two-class method for computing EPS, and requires affected companies to retroactively restate EPS amounts presented.

THE TWO-CLASS METHOD

The two-class method is an earnings allocation formula for computing EPS. It determines EPS for each class of common stock and participating securities according to dividends declared or accumulated and participation rights in undistributed earnings. Statement 128 requires companies with participating securities or more than one class of common stock to use this method to compute EPS.²

A “PARTICIPATING SECURITY”

Companies found it difficult to apply the description of a participating security in Statement 128,³ so the EITF developed this formal definition of the term: “A security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not, regardless of the form of participation.”

(1) EITF Issue No. 03-6, “Participating Securities and the Two-Class Method under FASB Statement 128”

(2) FASB Statement 128, Earnings per Share, February 1997.

(3) FASB Statement 128, Earnings per Share, February 1997, paragraph 60a.

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Under this definition, securities or other contracts that entitle their holders to obtain common stock (such as options, warrants, forwards, convertible debt, and convertible preferred stock) are participating securities if they can participate in undistributed earnings with common shareholders. According to the Consensus, awards accounted for under stock-compensation literature, such as options and non-vested stock, are not considered participating securities for EPS purposes before they are fully vested, even if such instruments entitle their holders to receive dividends along with holders of common stock prior to vesting.

Provisions of convertible securities that reduce the conversion price or increase the conversion ratio when dividends to common shareholders are declared are not participation features for EPS computations.⁴ In contrast, a provision in a forward contract to issue an entity's equity shares that reduces the contract price per share when dividends are declared is a participation right for EPS calculations, assuming it noncontingently transfers value to the holder of the forward contract if dividends are declared. All of the forward contract's relevant terms must be considered in determining whether value is noncontingently transferred to the holder of the forward contract.

ALLOCATING EARNINGS AND LOSSES

Net earnings must be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends or other participation payments that are paid or accumulated for the current period. Undistributed earnings for a period should be allocated to a participating security based on the contractual participation rights of the security to share in those current earnings assuming all earnings for the period are distributed. This is not a fair-value form of analysis. It is an allocation process based on the terms of the securities.

An entity would allocate losses to a participating security in periods of net loss if the participating security's contractual terms provide not only the right to participate in the issuer's earnings, but also an obligation to share in the issuing entity's losses on a basis that is objectively determinable. For purposes of applying this guidance, a participating security holder has an *obligation to share in the losses of the issuing entity* if the holder is obligated to fund the issuing entity's losses (i.e., the holder is obligated to write a check

EXAMPLE—PARTICIPATING CONVERTIBLE PREFERRED STOCK

Assume that Company X has 10,000 shares of common stock and 5,000 shares of preferred stock outstanding during 20X4, and has net income of \$115,000. Each share of preferred stock is convertible into two shares of common stock. The preferred stock is entitled to a non-cumulative annual dividend of \$5 per share. After the common stock has been paid a dividend of \$2 per share, the preferred stock then participates in any additional dividends on a 40:60 per share ratio with the common. For 20X4, the common shareholders have been paid \$26,000 (or \$2.60 per share), and the preferred shareholders have been paid \$27,000 (or \$5.40 per share). Basic earnings per share under the two-class method for 20X4 would be computed as follows:

Net income		\$115,000
Less dividends paid:		
Common	\$26,000	
Preferred	<u>27,000</u>	<u>53,000</u>
Undistributed 20X1 earnings		\$62,000

Allocation of undistributed earnings:

To preferred:

$$0.4(5,000) \div [0.4(5,000) + 0.6(10,000)] \times \$62,000 = \$15,500$$

$$\$15,500 \div 5,000 \text{ shares} = \$3.10 \text{ per share}$$

To common:

$$0.6(10,000) \div [0.4(5,000) + 0.6(10,000)] \times \$62,000 = \$46,500$$

$$\$46,500 \div 10,000 \text{ shares} = \$4.65 \text{ per share}$$

Basic earnings per share amounts:

	Preferred	Common
Distributed earnings	\$5.40	\$2.60
Undistributed earnings	<u>3.10</u>	<u>4.65</u>
Totals	\$8.50	\$7.25

(4) Companies should consider the effect of other accounting literature (e.g., guidance regarding beneficial conversion features) when the conversion price or conversion ratio of a security is adjusted.



without any corresponding increase in the holder’s investment interest) or if losses incurred by the issuing entity reduce the participating security’s principal or mandatory redemption amount. A holder is *not* obligated to share in the losses of the issuing entity solely because the losses reduce the holder’s liquidation preference or reduce the issuing entity’s ability to pay dividends to the participating security holder in the future.

The two-class method is now required for participating convertible securities when computing basic EPS. This changes earlier GAAP guidance, which permitted companies to make an accounting policy election to use the if-converted method, rather than the two-class method, in the basic EPS computation as long as the if-converted method was not less dilutive than the two-class method. The Consensus nullifies the earlier guidance.⁵

PRESENTATION AND DISCLOSURE

Presentation of basic and diluted EPS for securities other than common stock is not required, but it is permitted. What is required is the adjustment to the earnings that are used to compute EPS for the common stock. The Consensus does not affect Statement 128’s other required disclosures, including basic and diluted EPS for each class of common stock (e.g., presentation of EPS information for tracking stocks continues to be required).

TRANSITION

The guidance in the Consensus is effective for reporting periods beginning after March 31, 2004 and should be applied by restating previously reported EPS. Companies will therefore need to examine existing instruments in light of the Consensus to determine whether EPS adjustments are necessary for prior periods.

The descriptive and summary statements in this document are not intended to substitute for the text of Statement 128, EITF 03-6, and related guidance, and companies should not treat such information as applicable to their particular circumstances. They should consult the relevant GAAP and their accounting and legal advisors regarding the application of Statement 128, EITF 03-6, and related guidance.

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(5) EITF 03-6 nullifies EITF Topic No. D-95, “Effect of Participating Convertible Securities on the Computation of Basic Earnings per Share.”