Economic consequences of financial reporting changes: diluted EPS and contingent convertible securities

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Notes

1. See EITF Issue No. 04–8, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share."

2. Consistent with Holthausen and Leftwich (1983, p. 77), we view accounting choices as having economic consequences "if changes in the rules used to calculate accounting numbers alter the distribution of firms' cash flows, or the wealth of parties who use those numbers for contracting or decision making."

6. application guidance like that previously found in Staff Implementation Guides and Staff Announcements. Before issuing an FSP, the FASB staff circulates a draft of a proposed FSP to board members for review. If a majority of the board does not object to the proposed FSP, it is announced at an open public meeting of the board. Following the meeting, the proposed FSP is posted to the FASB website for a comment period and is announced in that day's Action Alert. At the end of the comment period, the FASB staff drafts the final FSP. As with the proposed FSP, if a majority of the board does not object to the final FSP, it is posted to the FASB website and announced in the Action Alert. The FSP is intended to ensure more timely and consistent communication about the application of FASB literature than the previous procedures (see http://www.fasb.org).

7. In cases where the COCOs are anti-dilutive to EPS, or where the contingency

transition rules of EITF 04-8 were ratified, GM followed up its original announcement with an irrevocable election by the board directors on November 5, 2004, to settle par values in cash, thereby securing their right to apply the treasury stock method of calculating diluted EPS to their outstanding COCOs.

10. Consistent with PPL's reasoning, prior empirical research shows that stock prices reflect dilution of EPS (see Core, Guay, & Kothari, 2002; Huson, Scott, & Wier, 2001; or Jennings, LeClere, & Thompson, 1997).

11. Brennan and Schwartz (1977) present conditions under which it is optimal to call convertible bonds.

assumption is that the term “EPS” refers to diluted EPS, as this is the figure that equity analysts forecast and investors use in valuation.

17. To the extent that firms respond to EITF 04-8 through means other than exchange offers or irrevocable elections to settle par values in cash rather than stock, there is potential for measurement error in our *RESTRUCTURE* variable. For example, firms may initiate or accelerate stock repurchase programs to offset the dilutive effects of EITF 04-8. A preliminary review revealed no evidence that such responses were taken by sample firms, perhaps because such action would impact basic as well as diluted EPS. In addition, any misclassification error will bias our tests *against* finding significant differences across the two groups.

21. As previously indicated, for firms with multiple offerings, *TRIGMET* is calculated using the average conversion trigger for all of the COCOs outstanding (typically two) compared with the firm's stock price. For all but five firms in the sample with multiple offerings, either all of the COCOs had hit the trigger or none had. We assess the sensitivity of our results to two alternative definitions. First, we exclude five firms from the analysis where at least one COCO had hit the trigger and at least one had not. In the second set of tests, we redefine *TRIGMET* to equal one if the stock price threshold for conversion had been met for all of the outstanding COCOs. In both cases, results for all three models remain similar to those reported in Table 4, although the *TRIGMET* variable becomes somewhat less significant.

22. As an additional sensitivity test, we also exclude the firm 3 M from the sample. This company did not restructure its COCO but also did not comply

results that are qualitatively similar but have reduced significance levels. These findings suggest that market participants needed a relatively longer period to learn of the rule changes and/or interpret their effects on COCO issuers. However, to rule out the possibility that our results are driven by the longer return window, we perform a randomization test in which we randomly choose six dates during our event period, create three-day, five-day, or seven-day windows around each date, and run the time-series regression in Eq. 1. We repeat this procedure 100 times. Using an absolute *t*-statistic cutoff of 1.96, we expect the null hypothesis of no abnormal return to be rejected approximately 5% of the time. Using the 600 estimated coefficients resulting from this analysis, we reject the null at rates of 6.2%, 5.2 percent, and 4.5% for the three-, five-, and seven-day windows, respectively. In addition, a test of the cumulative returns across all six dates is rejected at a 5% rate for all three window lengths. We thus conclude that and repeat our analysis. The t-statistic for the mean effect around R2 increases in its significance level when these firms are dropped (−2.49 vs. the −2.21 reported in Table 3). We thus conclude that any confounding effects from earnings announcements are unlikely to affect our inferences.

29. We perform White's (1980) test of heteroskedasticity for each column in Table 8. In every case, we cannot reject the null hypothesis of homoscedastic error terms at conventional levels of significance.

30. As a sensitivity test, we also included the other cross-sectional variables from Panel B in our disclosure model. None were significantly associated with shareholder reactions around events D1 and D2.

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