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LETTER OF COMMENT NO. 5

March 27, 2007

Director  
Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**RE: Proposed FASB Staff Position No. FAS 128-a, "Computational Guidance for Computing Diluted EPS under the Two-Class Method"**

Dear Technical Director:

We appreciate the opportunity to comment on proposed FASB Staff Position No. FAS 128-a, "Computational Guidance for Computing Diluted EPS under the Two-Class Method." We believe the illustrations contained in the proposed FSP are consistent with the requirements of FASB Statement No. 128, *Earnings per Share*, and that providing these illustrations in a final FSP will assist financial statement preparers in making their EPS calculations when the two-class method is required. However, we believe the "three-step process" described in the proposed FSP does not properly articulate the required approach to computing diluted EPS and therefore may confuse some constituents. We suggest using alternative language described below and using the examples to illustrate the mechanics of the process. We also believe the illustrations in the FSP should be included in Appendix C of Statement 128 for ease of reference and retrieval. We discuss these comments further below.

**Three-Step Process**

The calculation of diluted EPS under Statement 128 represents an instrument-by-instrument process of evaluating the dilutive impact of each potential common share in sequence, whereas the three-step process in the proposed FSP describes a new computational approach that, in our view, does not reflect the antidilution sequencing that we believe the staff is trying to convey and that Statement 128 requires. In particular:

- Step 1 is unnecessary because basic EPS is the benchmark for determining whether the assumed exercise or conversion of a potential common share is dilutive. Calculating basic EPS is not a step in calculating diluted EPS per se and not a step unique to entities with participating securities.



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- Step 2 states that Steps 2a and 2b are distinct “approaches” that are applied to participating securities that are also potential common shares. We do not believe there are two approaches to determining the impact of potential common shares that are also participating securities. Rather, we expect that each potential common share would be considered in turn to determine whether the effect of assuming conversion or exercise is dilutive. This is no different for a participating security that is also a potential common share than for any other potential common share. However, the existence of participating securities means that additional numerator adjustments must be considered. When income is adjusted in calculating diluted EPS, the share of net income of each class of securities may change. Further, when participating securities are assumed to be converted or exercised they are no longer entitled to a share of income via the two-class method. Instead, there is an adjustment to the denominator of the EPS computation. Thus, the basic method for determining whether assumed exercise or conversion of a potential common share is dilutive to basic EPS is—
  - Common shares that may be issued upon exercise of options (including participating options) are included in dilutive EPS using *the treasury stock method if assumed exercise is dilutive*
  - Common shares that may be issued upon conversion of convertible instruments (including participating convertible instruments) are included in dilutive EPS using the if-converted method if assumed conversion is dilutive.

In each case, we believe that the income available to common shareholders (the numerator of the EPS computation) must be recomputed based on a) the adjusted number of participating securities assumed to be outstanding and b) the adjusted amount of net income available for distribution to securities that participate in net income.

In contrast, Step 2 of the proposed FSP suggests that when determining whether exercise or conversion of a potential common share that is also a participating security is dilutive, all other potential common shares (whether more dilutive or less dilutive than the issue being considered) should be considered in the calculation. While this may result in an identical outcome in many cases, we do not believe this approach reflects the instrument-by-



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instrument antidilution requirements of Statement 128.

- Step 3 is not a step in calculating diluted EPS for a class of shares. Rather, it is a reminder that diluted EPS must be calculated for each class of common stock.

As such, we suggest replacing paragraph 4 of the proposed FSP with the following:

- “4. When participating securities are outstanding during a period, diluted EPS shall be calculated using the guidance in Statement 128, including the guidance on antidilution sequencing, allocation of undistributed earnings to participating securities, and the dilutive impact of potential common shares. Under that guidance, potential common shares (including potential common shares that are also participating securities) are included in the computation of diluted EPS if the effect of assuming conversion or exercise as of the beginning of the period (or issuance, if later) is dilutive. These calculations shall be performed for each potential common share in sequence from the most dilutive to the least dilutive.
- 4A. In the diluted EPS calculations, the allocation of total earnings using the two-class method shall be reallocated if a) net income would have been different assuming exercise or conversion of potential common shares or b) participating securities that are also potential common shares are assumed to be exercised or converted. Participating securities that are not potential common shares, and participating securities that are potential common shares but are antidilutive, are allocated a portion of net income (as adjusted for the numerator effects of assuming conversion or exercise of dilutive potential common shares) based on their contractual rights assuming all adjusted net income was distributed during the period.
- 4B. If there are multiple classes of common stock, diluted EPS for each class of participating common stock shall be computed using the two-class method assuming conversion of other classes of participating common stock. For a class of common stock convertible into another class of common stock, an entity shall disclose the fact that (a) diluted EPS for the convertible class of common stock does not assume conversion into another class of common stock and (b) diluted EPS for the class of common stock into which the convertible stock is convertible assumes conversion into that class of common stock, if dilutive.”



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**Other Comments**

Because the proposed FSP principally represents a set of computational examples to assist practitioners in applying Statement 128, we believe the examples should be included as Illustrations in Appendix C of Statement 128. The Board should also consider amending Statement 128 to update the language in paragraphs 60 and 61 of Statement 128 for clarity and consistency with the guidance in this proposed FSP and EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128".

\* \* \* \* \*

If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909- 5419 or Paul Munter at (212) 909-5567.

Sincerely,

**KPMG LLP**