



Letter of Comment No: //
File Reference: 1240-001

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November 30, 2005

Technical Director
File Reference 1240-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Exposure Draft: *Earnings per Share*, Proposed Amendment of FASB Statement No. 128 (File Reference 1240-001)

Dear Technical Director:

We appreciate the opportunity to respond to the Financial Accounting Standards Board's exposure draft of the proposed amendment to FASB Statement No. 128, *Earnings per Share*. We agree with and support the changes to Statement 128 as set forth in the proposed amendment. We also agree with the acknowledgment in paragraph A14 of the proposed amendment that there are unresolved practice issues about whether some instruments should be considered convertible debt instruments, contingent share arrangements, or instruments subject to the treasury stock method, and we support the Board's decision to address those issues in connection with its project on liabilities and equity. While we agree with the changes made in the proposed amendment and support the issuance of a final standard to amend Statement 128, we have the following comments on aspects of those changes that should be addressed to promote consistency in applying the revised guidance.

Assumed Proceeds in Applying the Treasury Stock Method

The proposed amendment would revise paragraph 21 of Statement 128 to require that the carrying amount of any liability recognized for the instrument being exercised or share settled that would be extinguished upon exercise or share settlement be included in the assumed proceeds for purposes of applying the treasury stock method. Based on the Board's rationale for this change as described in paragraph A13 of the proposed amendment, we believe the same treatment should be applied to written put options and other instruments subject to the reverse treasury stock method. That is, paragraph 24(a) of Statement 128 should be revised to specify that "Issuance of sufficient common shares shall be assumed at the beginning of the period (at the average market price during the



FASB Technical Director
November 30, 2005
Page 2 of 4

period) to raise enough proceeds to satisfy the contract *after deducting the carrying amount of any liability recognized for the instrument being exercised or share settled that would be extinguished upon exercise or share settlement.*” Based on this clarification, footnote 14 to paragraph 24 of Statement 128 would be revised as follows: “For example, Corporation Z sells 100 put options with an exercise price of \$25; the average market price for the period is \$20; *and the carrying value of the liability for each put option is \$7.* In computing diluted EPS at the end of the period, Corporation Z assumes it issues 90 shares to satisfy its put obligation, *after deducting the carrying amount of the liability for the put options, of \$1,800 ($\$2,500 - (100 * \$7)$).* The difference between the 90 shares issued and the 100 shares received from satisfying the contract (*a net reduction of 10 shares*) indicates that the contract would not be included in the computation of diluted earnings per share because it is antidilutive.” We believe this clarification is necessary to maintain consistency between the application of the treasury stock method and reverse treasury stock method. If those suggested revisions are not reflected in the final standard, the guidance being deleted from paragraph 29 that required a numerator adjustment for a contract that is reported as an asset or liability for accounting purposes may need to be retained for contracts that are subject to the reverse treasury stock method (e.g., net-share-settled written put options).

An equity derivative contract may be classified as an asset at the end of a reporting period but still have a dilutive impact because the number of shares assumed repurchased under the treasury stock method is based on the average stock price for the period rather than the period-end stock price. For example, a forward contract to sell an entity’s own equity shares that does not meet the requirements for equity classification in EITF 00-19 could have a dilutive impact even though it is in an asset position at the end of the period due to a sharp decline in the entity’s stock price near the end of the period. To address those potential circumstances, we believe the guidance in paragraph 21 of the proposed amendment should specify that the assumed proceeds under the treasury stock method should be *reduced* by the carrying amount of an asset recognized for a dilutive instrument that may be settled in shares. This clarification would be similar to the guidance in paragraph 21 that assumed tax shortfalls under share-based payment arrangements that would reduce paid-in capital should be treated as a reduction of assumed proceeds in applying the treasury stock method.

Mandatorily Convertible Financial Instruments

Although illustrations 1 – 3 of Statement 128 are being modified to reflect the changes made by the proposed amendment, we believe additional illustrations would be helpful regarding application of the new guidance on mandatorily convertible shares. We have included a number of potential examples for your consideration in the appendix to this letter.



FASB Technical Director
November 30, 2005
Page 3 of 4

The definition of *mandatorily convertible instrument* in the proposed amendment indicates that “an instrument that will convert into a variable number of shares is not a mandatorily convertible instrument because a contingency remains (the number of shares is not known), *unless there is a minimum number of shares that will be issued.*” As illustrated in certain of the examples in the appendix to this letter, it is unclear how the potentially issuable shares in excess of the minimum number should be reflected in the computation of diluted EPS. The final standard should indicate whether the remaining shares that may be issued should be included in diluted EPS in a manner similar to (a) the treasury stock method, based on the average stock price for the period, or (b) contingently issuable shares, based on the stock price or other conditions as they exist at the end of the reporting period.

Linking Related Instruments for EPS Purposes

Certain equity unit structures, which are commonly referred to as “mandatorily convertibles” in practice, may include (1) a variable share forward sale contract on the issuer’s own equity shares and (2) a debt instrument. The two components comprise an equity unit and are issued together for purposes of marketing and trading. However, the two components could be separated at the holder’s discretion, subject to contractual requirements to provide substitute collateral for the holder’s obligation under the forward contract.

Economically, the issuer’s obligation under the debt instrument may ultimately be offset against the holder’s obligation under the variable share forward sale contract and no cash (or a minimal amount of cash) may be exchanged at settlement. If the freestanding contracts were considered in combination and there is a minimum number of shares that would be issued under the variable share forward contract, the combined instrument may be deemed mandatorily convertible under the proposed amendment (similar to Example #5 in the appendix to this letter). Alternatively, if the EPS treatment were applied in a manner consistent with the separate accounting treatment given to freestanding instruments, then the contracts would not be considered mandatorily convertible.

We recognize that guidance on linkage of financial instruments for EPS purposes may be beyond the scope of this short-term convergence project. However, we encourage the Board to consider whether freestanding instruments should be combined for purposes of calculating EPS in its project on liabilities and equity.

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FASB Technical Director

November 30, 2005

Page 4 of 4

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, Paul Munter at (212) 909-5567, or Steve Douglas at (212) 909-5911.

Sincerely,

KPMG LLP



Appendix: Illustrative Evaluations of Whether Securities Are Mandatorily Convertible

Example 1 – Mandatorily Convertible Instrument for a Variable Number of Shares

On January 1, 20X1, Company A issues 100 shares of convertible preferred stock that may be converted at the option of the holder into a number of common shares determined by dividing the liquidation preference (\$1,000 per share) by a fixed price of \$10 per share at any time. However, if the holder does not convert the preferred stock into common stock by January 1, 20X9, Company A is required to redeem each share of preferred stock in exchange for a variable number of common shares with a then-current value equal to \$1,000.

The preferred stock is a mandatorily convertible instrument because it is certain that a minimum of 10,000 shares of common stock will be issued. If the fair value of Company A's common stock is at least \$10 immediately prior to maturity, the preferred shares will be converted by the holder and 10,000 shares of common stock will be issued. If the fair value of Company A's common stock is less than \$10 immediately prior to maturity, the preferred shares will not be converted by the holder and Company A will be required to deliver a variable number of common shares with a then-current value equal to \$1,000 (which would require the issuance of more than 10,000 common shares if the fair value per share is less than \$10).

The appropriate diluted EPS treatment of the potentially issuable shares in excess of the 10,000 share minimum in this example would also need to be addressed.

Example 2 – Mandatorily Convertible Instrument for a Variable Number of Shares

Company A issues 100 shares of 4% cumulative fixed-rate preferred stock that are required to be converted into a number of common shares determined by dividing the liquidation preference (equal to the \$1,000 per share stated amount plus any cumulative, unpaid dividends) by a fixed price of \$10 per share at a specified date in 5 years. Company A has the option of paying dividends in cash or allowing them to accumulate as an increase to the liquidation preference, which will result in additional shares issuable upon conversion. Company A's stated policy is to pay no dividends in cash and allow them to accumulate until the mandatory conversion date. As such, Company A expects to accumulate \$20,000 of unpaid dividends [$(\$1,000 \text{ face amount} * 4\% * 5 \text{ years} = \$200 \text{ per share}) * 100 \text{ shares}$] during the 5-year period the instrument is outstanding, which would result in the issuance of 12,000 shares of common stock [$(\$100,000 \text{ face amount of } 100 \text{ shares} + \$20,000 \text{ unpaid dividends}) / \$10 \text{ per share conversion price}$] on the mandatory conversion date.

The preferred stock is a mandatorily convertible instrument because it is certain that a minimum of 10,000 shares of common stock will be issued. The 2,000 additional shares related to unpaid dividends should not be included in basic EPS because Company A retains the right to settle the unpaid dividends in cash at any time prior to that date.



The appropriate diluted EPS treatment of the shares that may be issued to satisfy the cumulative dividends in this example would also need to be addressed.

Example 3 – Forward Sale Contract

On June 30, 20X5, Company A enters into a contract to issue 1,000 shares of its common stock to counterparty on December 31, 20X5 for a fixed cash payment of \$50,000, due at settlement. The counterparty does not participate in dividends declared by Company A during the term of the forward contract.

The contract is not a mandatorily convertible instrument because it requires consideration from the counterparty at settlement.

Example 4 – Prepaid Forward Sale Contract

On June 30, 20X5, Company A enters into a contract to issue 1,000 shares of its common stock to counterparty on December 31, 20X5 for a fixed cash payment of \$50,000, due at inception. The counterparty does not participate in dividends declared by Company during the term of the forward contract.

The contract is a mandatorily convertible instrument because the holder is required to exchange the instrument for a fixed number of common shares at a specified future date with little or no consideration upon the exchange other than tendering the instrument.

Example 5 – Prepaid Variable Share Forward Sales Contract

Company A enters into a contract to issue shares of its common stock to counterparty in exchange for \$50,000, due at inception. If Company A's share price is equal to or less than \$50 on the settlement date, Company A will issue 1,000 shares to counterparty. If the share price is greater than \$50 but equal to or less than \$60, Company A will issue \$50,000 worth of shares to counterparty. Finally, if the share price is greater than \$60, Company A will issue 833 shares to counterparty. At inception, the share price is \$49.

The contract is a mandatorily convertible instrument because the holder is required to exchange the instrument for a minimum number of common shares (833 share minimum) at a specified future date with little or no consideration upon the exchange other than tendering the instrument.

The appropriate diluted EPS treatment of the 167 potentially issuable shares in excess of the 833 share minimum in this example would also need to be addressed.

Example 6 – Deep In-the-Money Warrants

In connection with a financing transaction, Company A issues 10,000 common stock purchase warrants with an exercise price of \$0.01 per share and a term of 10 years. Upon issuance, Company A's common stock price is \$50 per share.

The warrants appear to be mandatorily convertible instruments because, although the warrants are legally in the form of written call options, the nonsubstantive exercise price



indicates that issuance of the underlying shares will occur with little or no consideration upon the exchange other than tendering the instrument. Treatment as a mandatorily convertible instrument is consistent with the existing guidance on contingently issuable shares in paragraph 10 of Statement 128.