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Exposure Draft: Proposed FASB Statement, *Earnings per Share, an amendment of FASB Statement No. 128* (File Reference No. 1200-200)

Dear Ms. Bielstein:

We appreciate the opportunity to comment on the exposure draft (ED) of the FASB's proposed Statement, *Earnings per Share, an amendment of FASB Statement No. 128*. While we support the Board's ongoing efforts to converge with international financial reporting standards, we remain concerned that the Statement 128 EPS model is not sufficiently robust to address many of today's complex financial instruments—a point that is illustrated by our comments in this letter about mandatorily convertible securities. While we understand that the issues addressed in this ED focus on convergence with IAS 33, *Earnings per Share*, we believe that the FASB and IASB should undertake a joint project to reconsider the current EPS model in Statement 128 and IAS 33 with the ultimate goal of replacing that model with one that establishes principles related to the EPS presentation of the effects of complex and non-complex financial instruments. Our specific comments on the ED are discussed below.

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Computational guidance for calculating the number of incremental shares included in diluted shares when applying the treasury stock method

We agree with the proposal that the number of incremental shares included in quarterly and year-to-date diluted earnings per share should be computed using the average market price of common shares for the quarterly and year-to-date periods, respectively (paragraph 46 of the ED and proposed changes to illustration 1 in paragraph 148 of Statement 128).

In the proposal, the Board concludes that this financial statement metric could be improved by aligning the computational guidance in Statement 128 with IAS 33, so that the frequency of interim reporting does not affect the denominator used for year-to-date computations. We agree with the Board that an entity that reports earnings per share on a quarterly basis should report the same annual earnings per share as an entity that reports earnings per share only on an annual basis.

According to paragraph 11 of Statement 128, the objective of diluted earnings per share is to measure the performance of an entity over the reporting period while giving effect to all dilutive potential common shares that were outstanding during the period. We believe that this is the conceptual basis for the proposed change, and we agree that the denominator used for year-to-date computations of earnings per share should not be affected by the denominators used for the respective interim reporting.

We note that the ED does not propose the same treatment as IAS 33 (example 7) for contingently issuable shares in the diluted earnings per share computation. The final Statement should revise the computational guidance on contingently issuable shares (see illustration 3 in paragraph 152 of Appendix C of Statement 128) so that the number of incremental shares also would be included in the year-to-date diluted EPS calculation from the beginning of the year-to-date period. Under current U.S. GAAP as discussed in illustration 3, the calculation of the number of shares related to the *retail site contingency* is based on the average number of shares outstanding for the four quarters, while IAS considers the total number of shares at year-end as outstanding as of the beginning of the year.

Eliminating the provision that allows an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock

We agree with the proposed change to paragraph 29 of the Statement 128 (contracts that may be settled in stock or cash) to require that (1) it should be assumed (replacing *presumed*) that the contract would be settled in common stock and (2) the resulting



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potential common shares would be included in diluted earnings per share if the effect is dilutive.

We believe that this approach is consistent with the definition of a *potential common stock* in paragraph 171 of Statement 128. According to this definition, potential common stock represents a contract that may entitle its holder to obtain common stock. The fact that it is possible to settle the contract in shares is sufficient to qualify as potential common stock. Statement 128 notes that the objective of diluted earnings per share is “to measure the performance of an entity over the reporting period while giving effect to all dilutive potential common shares that were outstanding during the period.”

The words *may entitle* in the definition of a potential common stock imply that if it is possible that the holder would receive common shares, regardless of whether it is the holder's choice or the issuer's choice, the contract is considered to be a potential common stock. Therefore, an intent to settle in cash does not overcome the possibility that the holder may be entitled to receive common shares under the terms of the contract.

Even if cash settlement were possible and supported by the company's historical experience, we believe that the proposed change is preferable, and that the Board's proposal to change paragraph 29 of Statement 128 would result in diluted earnings per share calculations that are more consistent with the objectives of portraying the maximum potential dilution and achieving greater international comparability.

Requirement that shares that will be issued on conversion of a mandatorily convertible security be included in the weighted average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory

Conceptually, we agree that for purposes of calculating basic earnings per share, mandatorily convertible securities should be treated as shares outstanding from the date on which they become mandatorily convertible. Once the shares become mandatorily convertible, the potential for dilution has been resolved, and it is appropriate to reflect those securities in basic and diluted earnings per share. We understand that this is consistent with the current guidance of Statement 128.

Nonetheless, we believe the final amendment should be clarified with respect to:

- The point in time at which the common shares are included in basic EPS. Specifically, the final amendment should indicate whether the common shares are included in basic EPS at the date a mandatorily convertible security is issued or on the stated conversion date. We understand that certain mandatorily convertible



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instruments provide for a time lag between the conversion date and the date the underlying shares are delivered. We understand that under the proposed standard, basic EPS for those instruments should be affected from the date the securities become mandatorily convertible rather than at the conversion date. We believe that consistency in practice would result if this point is stated explicitly in the final standard.

- Whether the if-converted method would be used for the basic earnings per share calculation when shares that would be issued on conversion are treated as outstanding under the proposed guidance in the ED.
- The application to instruments that are mandatorily convertible into a fixed number of shares versus a variable number of shares (e.g., with a specified monetary value). If this guidance applies to instruments that are convertible into a variable number of shares, there are a number of computational questions. For example, would an instrument that is mandatorily convertible into a variable number of shares with a specified monetary value ever have an earnings per share effect? That provision functions as a share-settled mandatory redemption feature, and it is not clear whether an issuer should apply the reverse treasury stock method or the if-converted method in its basic earnings per share calculations. If the reverse treasury stock method were used, there might never be an earnings per share effect, similar to a written put option that is exercisable for fair value. However, if the if-converted method were used, the aggregate number of shares to be delivered on settlement would be included in basic earnings per share. If the if-converted method is applied to instruments that are mandatorily convertible into a variable number of shares, would the shares issuable be the number at the end of the reporting period if that were the mandatory conversion date, or should a weighted-average number of shares be computed based on the issuer's share price fluctuations throughout the reporting period?
- The application to an instrument that contains (i) a conversion option that can be exercised by the holder for a fixed number of shares at any time and (ii) a mandatory conversion feature that specifies that the instrument would convert into a variable number of shares with a fixed monetary value on a specified date (effectively a share-settled mandatory redemption feature). In those cases, conversion is certain to occur, although it is not clear how the proposed guidance in the ED would be applied to this instrument. Should the variable shares issuable on mandatory conversion be reflected in the basic earnings per share calculation, even though mandatory conversions into a variable number of shares is contingent on the holder not exercising the conversion option for a fixed number of shares?



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We understand that many of the issues we have raised currently exist in practice. However, in view of the other changes proposed in the ED, we believe that these issues will become more prevalent and, if not directly addressed, may result in inconsistent application of the new standard. Additionally, we believe that these and similar issues support our earlier assertion that the Board needs to reconsider the Statement 128 model. Finally, we suggest incorporating examples into the standard to enhance constituents' understanding of the guidance.

Effective date and transition

We agree with the Board's conclusion that retrospective application of the proposal is appropriate as retrospective application increases the comparability of earnings per share amounts among reporting periods. Additionally, retrospective application is consistent with the treatment of other changes that affect the earnings per share calculation.

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If you have questions about our comments or wish further to discuss any of the matters addressed herein, please contact John Guinan at (212) 909-5449 or Paul Munter at (212) 909-5567.

Sincerely,

KPMG LLP