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Letter of Comment No: 4
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Proposed FASB Staff Position No. 150-e, "Issuer's Accounting under Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable"

Dear Mr. Smith:

Deloitte & Touche LLP is pleased to comment on the proposed FASB Staff Position No. 150-e, "Issuer's Accounting under Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable" ("proposed FSP FAS 150-e")

After the issuance of FASB Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ("Statement 150"), there continued to be issues surrounding whether certain instruments should be classified as liabilities or equity. FSP FAS 150-1, "Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," addressed, through an example, the applicability of Statement 150 to warrants on shares that are redeemable immediately upon exercise of the warrant. However, there are differing interpretations on whether warrants on shares that are redeemable (excluding mandatorily redeemable shares) only after a substantive holding period subsequent to exercise of the warrant are liabilities pursuant to Statement 150. We understand the interpretation of paragraph 11 of Statement 150 as proffered in proposed FSP FAS 150-e that all warrants on shares that are redeemable should be classified as liabilities. However, we are concerned that the proposed interpretation may not be consistent with Statement 150 and the treatment of redeemable shares.

Much of the confusion on the issue of classification of warrants on redeemable shares is because Statement 150 does not address the classification of redeemable shares (not mandatorily redeemable). Current practice classifies redeemable shares as equity (albeit, not permanent equity if the issuer is a public company). In addition, Statement 150 does not clearly indicate whether its reference in paragraph 11 to settlement refers only to the settlement at maturity or exercise of the instrument being analyzed, or to the ultimate settlement, if any, of the shares underlying the instrument being analyzed.

We suggest that the FASB staff reconsider the need to issue the guidance in proposed FSP FAS 150-e and instead recommend that FASB complete phase two of its project on liabilities and equity as soon as practicable.

Support for a Different Interpretation

Because of these issues within Statement 150 (noted above), and because clear concepts delineating liabilities and equity have not yet been promulgated, there are a number of persuasive arguments, as discussed below, indicating that warrants for redeemable shares, where the shares must be held for a substantive period, should be classified as equity instruments.

The Instrument does not settle by transferring assets

In discussing the basis for the provisions of paragraph 11 of Statement 150, paragraph B26 indicates that instruments that (a) embody an obligation to repurchase the issuer's equity shares and (b) require the issuer to settle the obligation by transferring assets are within the scope of Statement 150 "because such instruments meet the current definition of liabilities in Concepts Statement 6...."

In analyzing an instrument that allows the holder to call a share that is immediately redeemable, the holder effectively has the means to require net cash settlement of the warrant. Thus, the ability of the holder to require cash upon settlement of the warrant indicates that the warrant should be classified as a liability under Concepts Statement No. 6, *Elements of Financial Statements*. However, a different situation exists when the issuer is obligated to deliver upon settlement of the warrant a share that appropriately meets the conceptual framework as equity and the issuer cannot be required to redeem such share for a substantive period. In this case, the warrant does not obligate the issuer to transfer assets (or issue a liability) but instead obligates the issuer to deliver an equity instrument and thus does not appear to meet the Concepts Statement 6 definition of a liability.

The Instrument Obligates the Issuer to Deliver a Fixed Number of Shares and Establishes an Ownership Relationship

Further, paragraph B40 of Statement 150 observes that the FASB proposed in its exposure draft that a financial instrument that embodies an obligation that requires settlement by issuance of a fixed number of the issuer's equity shares should be classified as equity. A warrant for a fixed number of shares, whether redeemable after a substantive holding period or never redeemable, appears to fit this description. These warrants provide all of the economic upside of equity consistent with the FASB's notion of an ownership relationship. Paragraph B40 of Statement 150 notes further that commentators generally supported this view that warrants for a fixed number of shares should be classified as equity and, ultimately, the Board did not reverse this view but instead decided to defer the resolution of the issue to phase two of the liability and equity project.

Consistency with the Model for Stock Options Subject to Statement 123(R)

In addition, we have previously responded to the FASB that there should be only one model for evaluating the classification of derivative financial instruments indexed to, and potentially settled in, a company's own stock, regardless of whether those instruments were issued for employee services, goods or other services, or other financial consideration. The staff position in proposed FSP FAS 150-e appears to contradict the FASB's position in FASB Statement No. 123(R), *Share-Based Payment* ("Statement 123(R)"). Statement 123(R) states that options granted to employees that give the employees the right to require the employer to repurchase the options for cash are not classified as liabilities provided that the repurchase feature does not permit the employee to avoid bearing the risks and rewards normally associated with equity ownership for a reasonable period of time, and provided it is not probable that the employer would prevent the employee from bearing the risks and rewards for

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a reasonable period of time. Paragraph 31 of Statement 123(R) states that a reasonable period of time is considered to be six months or more.

Because of the arguments noted above, supported by the principles in Statement 150, and the desire to avoid continuing to revise the classification of instruments as liabilities or equity on a piecemeal basis, we recommend that the FASB staff not issue proposed FSP FAS 150-e. Rather, the FASB should provide comprehensive principles in a Statement resulting from phase two of the liability and equity project as soon as practicable.

Deloitte & Touche LLP appreciates the opportunity to comment on proposed FSP FAS 150-e. If you have any questions concerning our comments, please contact Bob Uhl at (203) 761-3705.

Yours truly,

Deloitte & Touche LLP