Deloitte & Touche LLP 10 Westport Road P.O. Box 820 Wilton, CT 06897

Tel: 203-761-3705 Fax: 203-423-6705 www.us.deloitte.com

### Deloitte & Touche

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Lawrence Smith
Director, TA&I-FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. FAS 150-a

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

Dear Mr. Smith:

We are pleased to comment on the Proposed FASB Staff Position No. FAS 150-a, "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" (the "Proposed FSP").

We support the objective of the Proposed FSP, which is to clarify the application of paragraphs 11 and 12 of FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity ("FASB 150") to freestanding financial instruments composed of more than one option or forward contract embodying obligations. However, we believe the staff should make significant modifications to the Proposed FSP in order to fully meet that objective. Our primary concerns are:

 The Proposed FSP provides examples but does not provide definitive conclusions about the application of FASB 150 for most of those examples. As a result, the Proposed FSP is less useful than we believe it could be in conveying the principles underlying FASB 150 and, in some cases, it may raise more questions than it answers. File Reference No. FAS 150-a September 26, 2003

2. The Proposed FSP, in effect, devises a two-step analysis for determining whether a financial instrument composed of more than one option or forward is a liability pursuant to paragraph 12 of FASB 150. An interpretation of the term "predominant" is necessary in both steps, however, it is unclear whether the term used in the second step of the analysis is consistent with how it is used in paragraph 12 and explained in the basis for conclusions in FASB 150.

Each of those concerns is explained in more detail, along with some additional points, in Appendix A to this letter. We also provide suggested solutions to address our comments for the staff's consideration.

Finally, we understand that FASB 150 does not resolve all inconsistencies in the accounting treatment for economically similar obligations that have different forms of settlement and that the Proposed FSP cannot resolve those inconsistencies. We are nonetheless troubled by different accounting guidance and conclusions in the Proposed FSP for Examples 1 and 3, which we view as economically similar instruments. We suggest that this issue be prioritized as part of deliberations by the Financial Accounting Standards Board (the "Board") on phase 2 of the project for certain financial instruments with characteristics of both liabilities and equity.

We appreciate your consideration of our comments. Should you have any questions regarding our response, please contact Robert Uhl at (203) 761-3705 or James Johnson at (203) 761-3709.

Yours truly,

Deloitte & Touche LLP

# APPENDIX A DELOITTE & TOUCHE LLP COMMENTS Proposed FASB Staff Position No. FAS 150-a

#### 1. Need to Provide Definitive Conclusions

The Proposed FSP utilizes 6 examples to illustrate the application of paragraphs 11 and 12 in FASB 150. We commend the staff for making extensive use of examples to illustrate the guidance in the Proposed FSP. In general, we believe using specific examples tends to facilitate understanding of the objectives of the guidance and ultimately enhances the usefulness of the guidance. However, no definitive conclusions are reached in the Proposed FSP for Examples 3 through 6. The Proposed FSP indicates only that judgment must be used to determine whether a particular instrument is within the scope of FASB 150. We believe that, for the most part, constituents already are aware that the application of aspects of FASB 150 requires judgment.

We recommend that the Proposed FSP also include a discussion of the factors to be considered in exercising judgment in each example¹ and/or examples illustrating circumstances in which the conclusion as to whether the instrument is in or out of the scope is definitive. The objective would be to illustrate how preparers, practitioners, and others should apply judgment to reach definitive conclusions about what is the feature upon which the monetary value is predominantly based. That approach would greatly enhance the usefulness of the Proposed FSP's guidance.

To implement that suggestion, the Proposed FSP might add more examples by modifying the existing fact patterns to also illustrate for each of Examples 3 through 6 a circumstance in which it would be appropriate to conclude that the instrument is (or is not) a liability under FASB 150. To illustrate, we believe the judgments required in determining whether the instrument described in Example 4 is in the scope of FASB 150 concern such factors as the width of the share price range relative to the volatility of share prices. For example, if such an instrument were issued when the stock price were within the price range, had a wide price range and the underlying stock had a low volatility, and settled for a fixed amount if the stock price was within the range, it would be generally concluded that its monetary value is "predominantly based on a fixed monetary amount known at inception." The Proposed FSP could identify specific aspects of the instrument (e.g., the width of the share price range and the volatility of share price) that should be considered in exercising judgment about whether a particular transaction is within the scope of FASB 150. That additional guidance could be followed up with an example of its application along the lines of the following:

Company D enters into a contract to issue shares of Company D's stock to Counterparty in exchange for \$18 on a specified date. If Company D's share price is equal to or less than \$20 on the settlement date, Company D will issue 1

<sup>&</sup>lt;sup>1</sup> The proposed FSP does discuss factors to consider in general terms at the beginning of the Answer to Question 2, but not specifically in the context of each example.

share to Counterparty. If the share price is greater than \$20 but equal to or less than \$60, the Company will issue \$20 worth of fractional shares to Counterparty. Finally, if the share price is greater than \$60, Company D will issue 0.8 shares. At inception, the share price is \$29. Company D's stock is determined to have very low volatility based on historical data and the implied volatility of an option with a comparable life.

Using the guidance in the Proposed FSP, we believe one would reach a definitive conclusion, under that set of facts, that the instrument is a liability under FASB 150.

Although we have used Example 4 as an illustration, we suggest a similar approach be taken with the other examples for which no definitive conclusion is provided.

## 2. Clarify use of the Term "Predominant" in the Paragraph 12 Analysis of Instruments Composed of More than One Option or Forward Contract

We believe the Proposed FSP devises a two-step analysis for determining whether a financial instrument composed of more than one option or forward is a liability pursuant to paragraph 12 of FASB 150. Under Step 1, one must assess whether at least one component of the financial instrument would be, if separately issued, a liability under paragraph 12 of FASB 150—that is one must assess whether there is an obligation whose monetary value is "predominantly" based on one of the three situations described in that paragraph. Under Step 2, one must assess the relative "predominance" of the paragraph 12 obligation compared to the other components in the instrument. Depending on which component within the instrument is deemed to be "predominant" under Step 2, the instrument may or may not be a liability. This second assessment is not explicitly prescribed in paragraph 12 of FASB 150.

Paragraph 12 in FASB 150, introduces the term "predominantly" as part of the guidance on determining whether certain share-settled obligations are in the scope of FASB 150. That paragraph states, in part:

A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or <u>predominantly</u> on any one of the following ... [Emphasis added]

We have generally read that guidance to clearly associate the word "predominantly" with how an obligation's <u>monetary value</u> is derived. That is, in applying the guidance in paragraph 12 to an obligation whose monetary value is not fixed, an issuer would need to determine what is the predominant source of changes in monetary value of the obligation.

The Proposed FSP uses the term "predominant" (or variations thereof such as "predominantly" or "predominance") in a variety of contexts, however, that term is not always explicitly tied to the notion of the obligation's monetary value as it is used in paragraph 12. Below are some of those uses of the term "predominant" in the Proposed FSP. We have emphasized the words we believe are associated grammatically with that term based on the way the guidance is currently written. Only the third bullet below appears to use the term consistent with its use in paragraph 12.

- The last sentence of the first paragraph of the Answer to Question 2 reads: "If one or more of those obligations to issue shares would not fall within the scope of paragraph 12, the instrument must be analyzed to determine whether contractual obligations that do fall within the scope of paragraph 12 are predominant."
- The following paragraph states that "The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant."
- The last sentence of Example 3 states, "The facts and circumstances should be considered in judging whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed amount know at inception..."
- The last sentence in the last paragraph before Example 5 states, "...unless it is judged that the possibility of having to issue a variable number of shares ... is predominant."
- The last sentence before Example 6 states, "That determination depends on whether the obligation to deliver a fixed number of shares...is predominant at inception."
- Example 6 states "If at inception the possibility that both the building will not be completed in two years and the put will be exercised is judged to be predominant. . ."

A consistent interpretation of this term is critical to understanding the application of paragraph 12, since the difference between being in or out of the scope of FASB 150 in the case of financial instruments composed of more than one option and forward hinges on judgments about whether the monetary value of an obligation is based predominantly on a particular factor. We are concerned that the use of this term in so many varied ways may create confusion for guidance in paragraph 12 that we had thought fairly straightforward.

We believe that Step 1 of the assessment requires an interpretation and application of the term "predominantly" that is consistent with paragraph 12 of FASB 150. However, we do not believe that is the case for Step 2. That is, it is unclear in the Proposed FSP what makes a component within a financial instrument composed of more than one option or forward the "predominant" obligation in the second step of the analysis. Example 3 suggests that the Step 2 assessment is based on which obligation contributes most to the

amount of monetary value of the instrument as a whole; however, in order to make that assessment, it appears that an assessment of the likelihood that stock prices will be above or below the strike price—that is, a prediction of the outcome of the contract—is required. On the other hand, Example 6 seems more explicit in suggesting the necessity of predicting the outcome of the contract by indicating that it is the possibility of exercise of the put that is key to the assessment. We believe that classification of an obligation based on the most likely outcome is a quite different classification model from what was developed in FASB 150. In fact, we recall that the Board considered and rejected a similar approach in its earlier deliberations on this project in favor of the components-based approach.

We appreciate the need to provide guidance on the accounting for these types of instruments and do not necessarily believe that the conclusions proposed under the FSP are inappropriate. However, we are concerned about the introduction of a different classification approach through the FSP process from the standpoint of the Board's due process. The root issue of how to classify financial instruments that have more than one component relates to determining classification of all compound instruments, not just those that are composed of two or more options or forward contracts. Therefore, we have considerable reservations about the introduction of an approach to classification based on the most likely outcome without the benefit of the Board's full due process and consideration in the broader context of all compound financial instruments that are in the scope of the project.

Notwithstanding the above concerns, we suggest the proposed FSP would be easier to apply if the staff explicitly described the two-step analysis that must be performed to determine whether an instrument composed of more than one option or forward contract is in the scope of FASB 150 if it may settle in shares.<sup>2</sup> We also believe that the Proposed FSP would be more useful if it:

- Provided specific guidance for undertaking Step 2, including a description in each of the examples of what factors must be assessed in determining whether the instrument in its entirety is a liability under paragraph 12
- Clarified how the term "predominantly" should be interpreted for each of the steps, and, if the meaning is different between Step 1 and Step 2, explicitly address that difference by either (a) reconciling the wording used in the second step assessment in the Proposed FSP to the wording used in the first step assessment (which we believe is consistent with paragraph 12 in FASB 150) or (b) using the term "predominant" exclusively in association with the Step 1 of the analysis and introduce new wording in Step 2 that better expresses what the staff believes is the appropriate basis for

<sup>&</sup>lt;sup>2</sup> Technically, the first step of the two-step analysis is necessary for all contracts. That is, if the instrument has a cash settlement feature, a first step must be undertaken to determine whether that cash settled feature would be in the scope of FASB 150. It is when the instrument is in the scope under paragraph 12 that a secondary assessment of the instrument as a whole is necessary.

making judgments about which obligations would be within the scope of FASB 150 under paragraph 12.

#### 3. Other Comments

We have the following additional comments on the Proposed FSP:

- We note that the definition of "freestanding financial instrument" in FASB 150 indicates that an instrument that is legally detachable and separately exercisable would be considered a freestanding instrument. Wouldn't the liquidity make-whole described in Example 5 meet that definition since the warrant is exercised separately and the liquidity make whole is also legally detachable (once the warrant is exercised the shares can be sold separately)? If that is the case, should the two components be separately analyzed to determine whether they are in the scope of FASB 150?
- In the draft analysis of EITF Issues that will be affected by FASB 150, we note that the earnings per share guidance provided in EITF Issue 88-9, "Put Warrants" (EITF 88-9), is to be nullified. We believe that the guidance provided under the third issue in EITF 88-9 describing the effect of put warrants on the earnings-per-share calculation is useful. We suggest that guidance be carried forward somewhere, for example, in an FSP or in guidance provided in EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" (EITF 00-19).
- Some of the examples in the Proposed FSP state that a puttable warrant, if determined
  not to be within the scope of FASB 150, should be evaluated under Emerging Issues
  Task Force No. 00-19. It is our understanding that whether a put warrant is in the
  scope of FASB 150 or EITF 00-19, a public company must account for put warrants
  as liabilities. Therefore, we recommend that the Proposed FSP state this explicitly.
- In the first sentence of Example 2, we believe that the word "to" should be "by" so that the sentence reads, "... can be put back by the holder."
- Example 6 refers to the "share-settleable puttable warrant described in Example 1."
   We believe the reference should be to Example 3 or Example 5 (Example 1 illustrates a cash settleable put warrant).
- Is a difference intended by the use of the term "share-settleable" in the heading under Example 3 and "share-settled" in the heading of Example 5?
- We recognize that the format and presentation of the guidance in FSPs continues to evolve. We note that the guidance on the application of this Proposed FSP that is

<sup>&</sup>lt;sup>3</sup> Although the draft guidance states that this guidance was nullified by FASB Statement No. 128, *Earnings per Share* (FASB 128), the EITF analysis in FASB 128 states that it did not affect EITF 88-9.

relevant to each specific example seems to be provided in the paragraph immediately preceding the example (although there is nothing in the FSP to indicate that is the case). To some, it may not be clear whether that guidance is instead part of the discussion of the previous example, since it immediately follows without any break or new heading. The staff might consider moving the guidance paragraphs under the heading of the relevant example itself and labeling it as background to the example.