

E & Y LLP

September 22, 2003

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

**Proposed FASB Staff Positions on Certain Issues Related to FASB Statement
No. 150, *Accounting for Certain Financial Instruments with
Characteristics of both Liabilities and Equity***

We appreciate the opportunity to comment on the above-referenced proposed FASB Staff Positions (FSPs). Overall, we believe that the proposed FSPs provide helpful guidance for preparers and auditors in applying the requirements of Statement 150 and in enhancing consistency in its application. However, we believe that the FASB should consider more fundamental changes to Statement 150 in connection with (a) its proposal to defer the transition date for mandatorily redeemable shares of nonpublic companies and (b) Phase II of the FASB's project on the accounting for instruments with characteristics of both liabilities and equity (the "Liabilities and Equity Project"). We also have suggested certain clarifying changes to the proposed FSPs. Our comments are discussed below and are organized by each proposed FSP.

FSP 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*

We believe that the FASB staff's analysis of the examples described in the proposed FSP is consistent with the requirements of Statement 150. However, we note that instruments with different settlement alternatives that otherwise have identical economic characteristics could be classified differently under the proposed FSP. For example, the instruments described in Examples 1 and 2 will always be classified as liabilities because they could require the issuer to deliver cash to settle the instruments. However, because the instrument described in Example 3 is share settleable, it may be classified as equity or as a liability, depending on whether the monetary value of the instrument is considered "predominantly" indexed to a fixed amount. We understand that the classification of financial instruments under Statement 150 (other than shares) generally is not dependent on the method of settlement of the instrument and, therefore, this conclusion appears somewhat inconsistent with that concept.¹

¹ For example, written put options must be classified as liabilities regardless of the form of settlement. This conclusion represented a significant departure from the pre-existing model for many of these instruments, and the model that still exists for many instruments outside the scope of Statement 150, described in EITF

Another anomaly appears to arise in Example 2. In that example, the FASB staff concluded that a warrant that can be exercised to acquire the issuer's shares that subsequently can be put to the issuer for cash is a liability under Statement 150. However, what is not discussed in the example is that if the shares resulting upon exercise of the warrant remain outstanding for a time before the holder exercises the put option, those shares would be optionally redeemable shares and therefore not subject to the guidance of Statement 150. That is, the outstanding shares would be classified as equity (although public companies must classify the potential redemption obligation outside of permanent equity). Accordingly, under the proposed FSP, an instrument that upon exercise will result in the issuance of an equity instrument must be classified as a liability.

We believe that the above described anomalies result from the FASB's unfortunate decision to split the Liabilities and Equity Project into two distinct phases. Accordingly, while we do not object to the FASB staff's interpretation of Statement 150, we encourage the FASB to reconsider whether the conclusions described in the proposed FSP are appropriate in connection with its ongoing Liabilities and Equity Project. Further, if the FASB agrees that these conclusions should be reevaluated in connection with Phase II of its Liabilities and Equity project, the FSPs should explain that the conclusions potentially could change in connection with that project.

The classification of the instruments described in Examples 3-5 depends on whether the monetary value of those instruments is "predominantly" indexed either to a fixed amount or to an amount that varies inversely to changes in the issuer's share price. However, the FASB staff reaches no conclusions about the actual classification of those instruments. The meaning of the term "predominantly" arises with some regularity in practice and Statement 150 includes little guidance on the meaning of this term. We strongly encourage the FASB staff to provide additional guidance regarding the application of this term by increasing the level of detail in the examples and reaching definitive conclusions on whether the instruments in question are "predominantly" indexed to either a fixed amount or to an amount that varies inversely to changes in the issuer's share price.

Finally, we note in the sentence preceding Example 4 that the FASB staff has concluded that puttable warrants not within the scope of Statement 150 are accounted for under Issue 00-19. We note that Issue 00-19 continues to permit private companies to apply the guidance in EITF Issue 88-9, "Put Warrants," and suggest that this point be clarified in the final FSP to avoid confusion.

FSP No. FAS 150-b: Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount that Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

While we understand that the FASB staff's proposal regarding the application of Statement 150 to the mandatorily redeemable instruments in question may be the only way to literally apply the requirements of Statement 150 to those instruments, we have significant conceptual concerns about the resulting accounting and presentation. The application of the proposed guidance would result in amounts (either debits or credits) being classified within equity when the issuer has no equity instruments; that is, the residual interest is "owned" by the holders of the mandatorily redeemable instruments, which are classified as liabilities. In essence, the FASB staff has provided for the bifurcation of these instruments into liability and equity components in a manner that is likely to be inconsistent with the bifurcation model developed in Phase II of the Liabilities and Equity Project. We believe that this presentation will result in significant confusion among financial statement users and we encourage the FASB to reconsider the accounting for these instruments.

While we believe that the mandatorily redeemable instruments in question are appropriately classified as liabilities under Statement 150, we believe that these instruments represent the ultimate residual equity interest in the issuing company and, therefore, it is inappropriate to adjust the value of the instruments with an offsetting entry to "equity." Rather, we believe that the residual interest should continue to be carried at book value, and any difference between book value and the amount paid upon redemption should be recognized as a gain or loss when the instrument is redeemed. We acknowledge that this approach would not result in carrying the instruments at their fair value and would require an amendment to Statement 150. However, we understand that the FASB intends to amend the transition requirements for nonpublic companies that issue these instruments and believe the FASB should consider an appropriate amendment to the recognition and measurement guidance of Statement 150 in connection with that amendment.

In the event that the FSP is finalized in substantially the same form as proposed, we have the following additional comments:

- Example 1 – We believe that to ensure a complete example, the fact that retained earnings are assumed to be zero on the date of adoption of Statement 150 should be clarified.
- Example 2 – We believe the word "redeemed" should be replaced with "redeemable," as the securities in question have not yet been redeemed.
- Both examples – We believe that the examples also should incorporate balances of accumulated other comprehensive income, similar to the illustration in paragraph A6 of Statement 150. That change also will further illustrate that recognition of other comprehensive income will result in changes in "interest on

Director, TA&I-FSP
September 22, 2003

Page 4

mandatorily redeemable shares," essentially recycling any recognized other comprehensive income into net income.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst + Young LLP