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LETTER OF COMMENT NO. 3

March 31, 2008

**FASB Preliminary Views *Financial Instruments with Characteristics of Equity***  
**File Reference No. 1550-100**

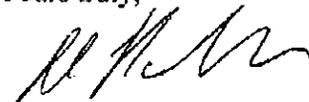
Dear Mr. Golden,

Enclosed is our letter of comment on the FASB Preliminary Views *Financial Instruments with Characteristics of Equity*. Our comments are solely related to the accounting treatment of derivatives on a reporting entity's own shares. The underlying concept of the comments is taken from the thesis *The Accounting Treatment of Derivatives on a Reporting Entity's Own Shares* which Dietmar Isert is going to submit to the University of Hohenheim in April 2008. The letter of comment is a response to the questions asked in Appendix E on page 65:

- *Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider?*
- *How would the approach classify and measure instruments?*
- *Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?*

If you have any questions regarding the comments, please contact Prof. Dr. Dirk Hachmeister at 0049-711-459-22913 or Dietmar Isert at 0049-179-5295597.

Yours truly,

  
Prof. Dr. Dirk Hachmeister

  
Dietmar Isert

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March 31, 2008

**FASB Preliminary Views *Financial Instruments with Characteristics of Equity***  
**File Reference No. 1550-100**

Dear Mr. Golden,

We appreciate the opportunity to comment on the *FASB Preliminary Views Financial Instru-  
ments with Characteristics of Equity* as follows:

**Appendix E – Questions on Other Alternatives (p. 65): *Is there a variation of any of the  
approaches described in this Preliminary Views or an alternative approach that the Board  
should consider?***

We believe that the FASB should consider classifying derivatives on an entity's own shares in a new (equity) category in a similar manner as proposed by the FASB Discussion Memorandum in 1990 (pp. 40-42). Such a new category could be labeled as 'equity derivatives' and could be considered as a (new) kind of equity instrument. However, instead of the term 'equity derivatives' other expressions could also be used. Derivatives on an entity's own shares that are classified in this new category would be displayed in the balance sheet either on the asset side (e.g. long call options) or on the liabilities and equity side (e.g. short put options). Such a new category could be regarded foremostly as a fourth category (liabilities, assets, and equity instruments such as common shares are regarded as the first three categories). If derivatives on an entity's own shares, such as short call or short put options, are recognized on the equity and liabilities side of the balance sheet, they may also be regarded as part of total equity. Moreover, if in financing instruments embedded derivatives on an entity's own shares are separated (e.g. an option to convert a bond into common shares of the reporting entity), the separated derivatives should also be classified in the new proposed category as 'equity derivatives'.

***How would the approach classify and measure instruments?***

We believe that derivatives on an entity's own shares should be classified in a new category and be displayed as 'equity derivatives' either on the asset side or on the equity and liabilities side of the balance sheet. This should be the case regardless of the form of settlement (physical, net share, or net cash). Derivatives in the category 'equity derivatives' are measured at the transaction price, i.e. at the consideration received (e.g. the premium received for a short call option) or at the consideration paid (e.g. the premium paid for a long put option) at the contract date and at fair value at each balance sheet date. Additionally, (fair value) changes of the carrying amount of these derivatives are directly recognized in the statement of changes in equity (in a similar manner as required for investments in debt and equity securities that are classified as 'available-for-sale'). Furthermore, 'equity derivatives' that are initially recognized on the equity and liabilities side of the balance sheet, such as short call or short put options, should be presented within equity. Thus, fair value changes of these derivatives do not change 'total equity', because fair value and thus carrying amount increases or decreases of these derivatives are offset by corresponding accounting entries in the statement of changes in equity.

***Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?***

In our view, the advantages of classifying physically settled derivatives on an entity's own shares as 'equity derivatives', as opposed to classifying them as financial assets and financial liabilities as required according to the FASB's preferred method, the basic ownership approach, are as follows:

The differences between derivatives on an entity's own shares and derivatives with other underlying items (e.g. shares in other entities and interest-bearing instruments) are illustrated as follows. On physical settlement of derivatives on an entity's own shares, in which the fair value moves in the same direction as market price changes of common shares, the reporting entity issues its own shares and receives a consideration (exercise price or forward price). The issuance of the reporting entity's own shares increases the resources under the control of the entity and thus both sides of the balance sheet. Examples of such derivatives, from the perspective of the reporting entity, are short forward contracts (i.e. forward sale contracts), short call options, and long put options. On physical settlement of derivatives on an entity's own shares, in which the fair value moves inversely to market price changes of common shares, the reporting entity repurchases its own shares and pays a consideration (exercise price or forward price). The repurchase of the entity's own shares decreases the resources under the control of the entity and thus both sides of the balance sheet. Examples of such derivatives, from the perspective of the reporting entity, are long forward contracts (i.e. forward purchase contracts), long call options, and short put options. In contrast to these transactions, the physical settlement of derivatives with other underlying items does not usually significantly change the total amount of both sides of the balance sheet. However, it should be noted that the physical settlement of derivatives on an entity's own debt instruments may also significantly change the total amount of both sides of the balance sheet. Furthermore, as opposed to derivatives with other underlyings, regardless of the form of settlement, derivatives on an entity's own shares possess equity characteristics, because the payoff varies either in the same direction or inversely to fair value changes of the common shares of the reporting entity. We believe that the differences between derivatives on an entity's own shares and derivatives with other underlying items support the classification of derivatives on an entity's own shares in the new category 'equity derivatives' rather than as financial assets or financial liabilities.

Furthermore, we believe that the comparability of financial statements through time and between different entities (as required according to SFAC 2.111) is an essential consideration when judging which accounting principle is the most appropriate regarding derivatives on an entity's own shares. In the instance where the reporting entity enters into a short forward contract on its own shares, the basic ownership approach does not fulfill the criterion 'comparability'. From the perspective of the reporting entity, the more its own share price increases, the more negative the fair value of the forward contract is. This means, in a scenario where the entity performs well, the market price of the shares and the (negative) fair value of the forward contract increases. Fair value changes of the common shares are not recognized in the financial statements. However, according to the basic ownership approach, the (negative) fair value change increase of the forward contract is recognized as a loss. Vice versa, if the entity performs poorly and the fair value of the forward contract decreases, a gain is recognized. In these scenarios, the comparability of earnings, as a measure of annual performance (see SFAC 5.34) of different years of the reporting entity is worsened.

Additionally, it is possible that the comparability of earnings as a measure of performance for specific periods between different entities is also worsened. Again, it is assumed that the reporting entity enters into a short forward contract on its own shares. It is also assumed that the reporting entity performs well, the share price increases, and a gain is recognized from the operating activities. From the perspective of the reporting entity, the more its own share price increases, the more negative the fair value of the forward contract is. According to the basic ownership approach, the (negative) fair value change increase of the forward contract is recognized as a loss. The comparability with other entities (which have not entered into such a forward contract) may be worsened in the instance where these other entities perform poorly, the share price decreases, and a loss is recognized from their operating activities. In such a scenario it would even be possible that these other entities record the same earnings for the period as the reporting entity. Consequently, the comparability of the earnings for the period between different entities would be worsened. To increase the comparability of financial statements regarding the effects on annual earnings through time and between different entities, we believe that fair value changes of derivatives on an entity's own shares should be recognized in the statement of changes in equity and not in profit or loss.

Moreover, it should be noted that, according to the basic ownership approach, in an instance where the reporting entity has entered into a warrant (i.e. a short call option contract on its own shares), the following effects on 'total equity' have to be taken into account. The more the market price of the common shares increases, the more negative the fair value of the warrant is from the perspective of the reporting entity. The recognition of the fair value change as a loss decreases 'total equity'. This means that the better (worse) the entity performs, the lower (higher) 'total equity' is disregarding other (earnings) effects on 'total equity'. Thus the comparability of 'total equity' through time and between different entities is also worsened. If, however, the warrant were to be classified as an 'equity derivative' and be presented within equity, as proposed in this comment letter, fair value changes of the warrant would be offset by corresponding accounting entries in the statement of changes in equity. Thus the amount of 'total equity' would remain constant.

The 1990 FASB Discussion Memorandum (pp. 85-86) notes that, according to the economic unit theory, the reporting entity should not be affected by fair value changes of instruments owned by one group of owners (e.g. the holders of warrants) at the cost of another group of owners (e.g. common shareholders). Thus, the economic entity theory supports the classification of derivatives on an entity's own shares as equity, as fair value changes of equity instruments are not recognized in the financial statements. Under the parent company theory, the

reporting entity should represent the perspective of the common shareholders (of the parent company). Fair value changes of derivatives on an entity's own shares (such as warrants) are at the cost or benefit of the common shareholders. Therefore, this theory supports the accounting treatment of derivatives on an entity's own shares as financial assets or financial liabilities, as fair value changes of financial asset and financial liability derivatives are recognized in profit or loss. We believe that the classification of derivatives on an entity's own shares as 'equity derivatives' could be regarded as a compromise to partly fulfill the requirements of the economic unit theory (classification as equity) and of the parent company theory (classification as financial asset or financial liability derivatives) simultaneously. This is the case, as, firstly, fair value changes of derivatives on an entity's own shares (such as warrants) do not affect the annual earnings, as required by the economic unit theory. And secondly, the fair values of these derivatives and changes thereof are recognized in the financial statements, as required by the parent company theory. Thus, the classification of derivatives on an entity's own shares as 'equity derivatives' simultaneously emphasizes the perspective of the common shareholders, and retains the comparability of the effects on earnings through time and between different entities.

It should be noted that the measurement of physical settled derivatives on an entity's own shares at fair value as required according to the basic ownership approach and according to the view presented in this comment letter has the following disadvantage: Physical settled derivatives on an entity's own shares measured at fair value do not present information about fixed (such as the forward price of a forward contract) or contingent (such as the exercise price of an option) cash inflows or cash outflows. The reasoning is as follows. Usually, the forward price significantly exceeds the fair value of a long (short) forward contract. At maturity of a forward contract, the reporting entity has the obligation (right) to pay (receive) the full forward price. Therefore, the fair value of a forward contract does not adequately reflect the expected future payment of the forward price and thus the expected outflow (inflow) of financial resources. Additionally, the fair value of options is usually significantly below the exercise price. Thus the fair value of options on an entity's own shares also does not provide an approximation of the potential cash inflow or cash outflow when these options are exercised at maturity. Measuring these derivatives at fair value is, in particular, for short put options and long forward contracts, a significant disadvantage, as no information is presented about the (potential) future cash outflows (exercise price or forward price) and thus about the ability of the reporting entity to meet its financial commitments as they are due. We believe that an appropriate approach to mitigate this disadvantage would be to reclassify the exercise price of short put options and the forward price of long forward contracts from permanent to temporary equity as required for public companies according to US-GAAP, EITF Issue No. 00-19.9 and 00-19.37, before the issuance of SFAS 150 in May 2003.

If the conclusion were to be reached that gross physical settled derivatives on an entity's own shares should be classified in the (new) category 'equity derivatives', as recommended above, we do not believe that net cash or net share settled derivatives on an entity's own shares should be classified as financial assets or financial liabilities for the following reasons. Firstly, at maturity of a physical settled derivative the (potential) payment of the exercise price or forward price is usually significantly above the fair value of the derivative contract. Thus, generally speaking, the effects on the liquidity and solvency of the reporting entity at maturity of physical settled derivatives significantly exceed the effects of net cash settled derivatives. This is the case, although (the direction of) the cash flows on physical settlement can differ tremendously between physical and net cash settled derivatives. For example, after the exercise of a physical settled short call option (warrant), the reporting entity receives the exercise price, whereas in the instance a net cash settled short call option is exercised, the reporting entity is obligated to

pay the fair value of the option. Secondly, we believe that complexity is reduced if all derivatives on an entity's own shares are classified as 'equity derivatives' regardless of whether physical, net cash or net share settlement is agreed upon, or if one of the contractual parties has the choice of how the option is settled. Thirdly, the payoff profile of physical settled derivatives on an entity's own shares is the same as the payoff profile of net share or net cash settled derivatives. Fourthly, in the instance the reporting entity has entered into a long call or a long put option on its own shares, the reporting entity is able to sell the option to a third party. The cash amount received from the sale of a long call or a long put option is usually identical regardless of the form of settlement. For these reasons, we believe that derivatives on an entity's own shares should be classified in the new category 'equity derivatives' regardless of the form of settlement.

Furthermore, we believe that only simple derivatives on an entity's own shares should be classified as 'equity derivatives', as described above. Complex derivatives should be classified as financial assets or financial liabilities in the instance that certain additional non-equity features are agreed upon. Such additional non-equity features are, for example, that the exercise of the option depends on the occurrence of an external event (such as the change of a stock market index, a foreign exchange rate, or a commodity price), or the number of the underlying shares or the amount of the exercise or forward price changes upon the occurrence of such an event.

The advantages of classifying derivatives on an entity's own shares as 'equity derivatives', and of the introduction of an accounting principle to reclassify both the exercise price of physical settled short put options and the forward price of physical settled long forward contracts from permanent to temporary equity, are presented above. In an overall assessment, we believe that these advantages outweigh the disadvantage of the increase in complexity that would result from both a new category ('equity derivatives') and a new accounting principle being introduced simultaneously. Furthermore, complexity could be reduced if all derivatives on an entity's own shares are classified as 'equity derivatives' regardless of the form of settlement.

Yours truly,



Prof. Dr. Dirk Hachmeister



Dietmar Isert