



May 24, 2007

LETTER OF COMMENT NO. 4

Mr. Larry Smith
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Financial Accounting Standards Board
401 Merritt 7
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Re: Proposed Statement 133 Implementation Issue No. C21, *Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates*

Dear Mr. Smith:

We appreciate the opportunity to comment on the abovementioned Proposed Statement 133 Implementation Issue ("Proposed Issue C21") and are grateful that the Board added this topic to its agenda. We believe that the questions addressed in this Issue have frustrated constituents for many years, because the *principle* underlying the primary current literature, Statement 133 Implementation Issue C8, "Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates" ("Issue C8"), has been almost impossible to discern. Other constituents, including many domiciled overseas, are simply unaware that Issue C8 poses a problem they should be analyzing. We believe that even though the issue has not received a great deal of publicity, the issue is pervasive and growing, as more and more foreign domiciled entities seek to register their shares in countries with currencies other than their functional currency, issue warrants on those shares, and issue debt convertible into those shares. Similarly, this is an issue for U.S. companies that may seek to list shares on developing stock exchanges overseas. As these developing markets mature, more U.S. companies will seek capital globally.

Though we appreciate the Board's addressing this issue, we are not satisfied with the response because this proposed guidance views the instruments in Examples 2 and 5 in Attachment A to Proposed Issue C21 as dual indexed to the issuer's own stock and foreign currency exchange rates. We believe this result is inconsistent with financial theory (e.g., option pricing theory and option exercise behavior) because forward rates for foreign currencies play no role in the fair value or settlement value for the instruments in these examples, or in the investor's decision to exercise those conversion options. We believe the analysis behind the conclusions for Examples

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2 and 5 has confused the concepts of currency *denomination* and currency *translation* with currency *indexing*, basing what should be a financial analysis of the terms of an instrument on a GAAP reporting concept—"functional currency". Accordingly, we believe that the Board's approach has been unnecessarily restrictive and built off an inappropriate concept. In our comments that follow, we elaborate on our view that the proposed model is not founded on the appropriate theory and propose an alternative view that we believe adds clarity to this complex issue.

Companies whose functional currency differs from the currency of the exchange on which their shares are primarily listed are typically multi-national entities with complex operations. The functional currency determination under FASB Statement No. 52, "Foreign Currency Translation" ("Statement 52"), is typically a challenging analysis where just one or two facts may have tipped the scale toward use of a functional currency other than that of the home country. Examples might include a Canadian energy exploration company that uses a U.S. dollar functional currency largely because crude oil sales are always denominated in the U.S. dollar. Another example might be a Chinese company with a local functional currency, but filing U.S. GAAP financials and listing on the NYSE in search of capital from a broader and more liquid U.S. market. Such companies are not seeking to make a "currency play." Often the acquisition or disposition of a single subsidiary could flip the fragile functional currency determination back to (or from) the country of domicile. By their nature, these companies are multi-national entities with operations in more than one currency that routinely issue common shares in exchange for cash in a non-functional currency. Why does it necessarily follow that if one of these companies issues an option on these same shares, such option is "dual indexed" and must be accounted for as a liability? Perhaps the company itself is better characterized as "dual indexed" by the nature of its international operations, but the instrument itself should not be considered dual indexed.

Complexity is Reduced When Derivatives Accounting is Faithful to Financial Theory. We believe that a principles-based approach to financial instrument accounting, particularly an approach that cites "fair value" as an ideal, should respect basic concepts in financial theory. We believe that the Board has missed a golden opportunity to reduce the complexity of Statement 133 in the proposed response in this Issue by not looking to option valuation theory in building the Proposed C21 model. The functional currency concept of Statement 52 is an accounting concept, not a financial concept. Building a "principle" that dual indexation is created when a strike price currency denomination does not match the outcome of a *functional currency determination* performed under the application of Appendix A of Statement 52 is tying the definition of "indexation" to a GAAP reporting concept and not to fair value or settlement value concepts upon which we believe EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock'" ("EITF 01-6") is built. EITF 01-6 requires that the instrument's settlement amount be based solely on the issuer's stock, and not on another underlying. As we

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will explain further, only the instruments in Examples 2 and 5 require no foreign currency inputs in the option valuation process to determine the fair value or the settlement amount. Accordingly, we believe that the Proposed Issue C21 approach is yet another Statement 133 “rule”.

Denominating vs. Indexing. We believe that the instruments in Examples 2 and 5 in Proposed Issue C21 are *not* dual indexed to the issuer’s own stock and foreign currency exchange rates, and that the analysis in the Issue confuses the concept of *denominating* an instrument with *indexing* an instrument. *Denominating* sets the settlement consideration; *indexing* introduces a term that causes some sort of variability. All financial instruments must be denominated, but we do not believe that denominating an instrument necessarily *indexes* that instrument as well. We urge the Board to redeliberate this Issue to conclude that Examples 2 and 5 are not dual indexed.

Proposed Issue C21 looks to facts outside the equity option—namely, the functional currency of the issuer—to determine whether the option has been indexed to the “incorrect” currency. If the functional currency of the issuer of the option is not the same as the currency in which the option’s exercise price is denominated, then the contract is deemed to be *dual indexed* from the point of view of the issuer, even if one would not be able to detect the dual indexation by reading the contract, or even care about it from the holder's perspective. Proposed Issue C21 implicitly justifies looking outside the contract to determine if there is a dual indexation condition because the only reason one is performing this analysis is to determine the accounting for the issuer and the issuer's ability to use the paragraph 11(a) exception in Statement 133. Therefore, the draft language seems to argue that it is relevant to look outside the contract terms to characteristics about the issuer to help in the analysis.

We disagree with this reasoning as the only acceptable logic and believe the Board is unnecessarily expanding the concepts in EITF 01-6, adding to the complexity of applying Statement 133, paragraph 11(a). This paragraph states that the reporting entity shall not consider contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders’ equity in its statement of financial position, to be derivatives. One must look to EITF 01-6 to assist with criterion (1) and EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock” (“EITF 00-19”), to assist with criterion (2). In theory, if one does not clear the hurdles of EITF 01-6, it is unnecessary to perform the analysis required of EITF 00-19 because liability classification is already required by the conclusion reached in applying EITF 01-6.

The response in Proposed Issue C21 does not acknowledge that a denomination decision for these financial instruments is not only unavoidable but also effectively predestined by the exchange on which the referenced shares are listed. In the examples in EITF 01-6 in which the

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instruments were determined to be dual indexed, the feature responsible for the second index was completely avoidable. For example, Instrument 4 of EITF 01-6 is a warrant to buy 100 shares of common stock in exchange for one ounce of gold. The insertion of the gold feature is avoidable. Such warrant is not considered indexed to the issuer's own stock because the settlement amount is based on the company's stock price and the price of one ounce of gold. The fair value of the warrant during its life is influenced by the company's stock price and the forward price of gold.

In Examples 2 and 5 of Proposed Issue C21, the unavoidable selection for the equity option's currency denomination is the currency in which the issuer's shares are traded. In other words, the exercise price is denominated quite logically in the currency in which the shares trade and the investor desires. (If shares trade on more than one exchange (such as shares on the Toronto exchange and American Depository Receipts on the NYSE), the option contracts typically specify which shares, Toronto or NYSE, are to be used to settle the contract.) The fair value of such an option will not be influenced in any way by changes in forward foreign currency exchange rates. The equity option valuation specialist does not need any information about the forward US\$ and CAN\$ exchange rate in these examples to determine the fair value of these equity options. Such information is extraneous to the investor's exercise decision and the "moneyness" of the option. The investor is oriented only to the market in which the shares he stands to acquire are trading, and is comparing those share prices to the strike price of his instrument. The option valuation model will determine the intrinsic value of the option and the time value of the option without any information about forward foreign exchange rates. Once the valuation is completed in the currency in which the strike price is denominated and the shares trade, the fair value can be expressed in whatever currency an entity desires by simple translation at spot exchange rates. Still, the settlement amount, representing the option's fair value at point of exercise, is based *solely* on the company's stock price. The settlement can be *denominated based on spot exchange rates* in any currency. The final currency exchange did not determine the fair value or the settlement value; it simply denominated the value in the desired currency. Accordingly, we do not believe that the instruments in Examples 2 and 5 of Proposed Issue C21 are similar to Instrument 4 of EITF 01-6.

"*Quanto*." In contrast, the instruments in Examples 1, 3, 4, and 6 are all dual indexed from the point of view of option pricing theory. We discussed these examples with our firm's derivative valuation specialists. In all four examples, the investor's likely payoffs are influenced by both a) the equity price movement and b) the forward foreign exchange movement, so both underlyings influence their likelihood of exercise, and accordingly their "in the moneyness." Our specialists pointed out that unlike Examples 2 and 5, the instruments in these other four examples require a significantly more complex valuation exercise known in the field as a *quanto*, or *cross-currency derivative*, adjustment. The valuation technique for the instruments in Examples 1, 3, 4, and 6

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must consider *both* the volatility of the stock price and the volatility of forward foreign exchange rates for an uncertain term, and the extent to which such volatilities are correlated to one another. This dual consideration is necessary because the market participants do not conduct their stock transactions in the currency in which the exercise price has been denominated, so there is neither historical stock price data nor implied stock price volatility data expressed in that currency. Accordingly, an overlay technique is necessary to integrate the quanto, or cross currency exposure adjustment.

There are various techniques that specialists may use in determining the quanto adjustment. One technique involves performing a full Monte Carlo simulation with both underlyings (e.g., equity price and US\$/CAN\$ forward rates) subject to variation to identify the paths leading to an intrinsic value for the option (and thus an assumed exercise) vs. the paths that would lead to no exercise. Another approach used is to recast the equity price historical volatility into a hybrid volatility that looks to historical equity prices converted at the then-spot foreign exchange rates into the currency in which the strike price has been denominated. Such a technique does not seek to ascertain implied market volatility. This technique is helpful but not intellectually pure unless it adjusts for the correlation effect, if any, between the equity price changes and the foreign exchange forward rate changes. A third technique will follow a standard option pricing model such as Black-Scholes, and then develop an on-top “quanto” adjustment that has been separately calculated to estimate the extent to which the equity price underlying correlates with the forward foreign currency exchange underlying. All approaches to determining the “quanto” effect are quite complex and usually necessitate the involvement of a valuation specialist.

In contrast, the instruments in Examples 2 and 5 consist of the “typical” application of an option valuation model such as Black Scholes to determine the fair value of the option in the currency in which the shares trade, which matches the denomination of the strike price. No consideration of forward foreign exchange rates (the “quanto” effect) is necessary to factor into the possible outcomes. Once the fair value of the option has been calculated, that fair value can be expressed in any alternative currency by simply applying the *spot* foreign exchange rate for the desired date. We believe that the statement in the Response to Question I of Proposed Issue C21 is factually incorrect when it says, “Because the consideration received by the issuer is denominated in a currency other than the issuer’s functional currency, its fair value to the issuer is affected by currency exchange rates.” This statement confuses the concepts of “ultimate proceeds received” with “fair value.” There is not a separate fair value “to the issuer” from the fair value “to the investor.” The fair value is the same for both the issuer and the investor, whether expressed in U.S. dollars, in euros, in Canadian dollars, or in Japanese yen. Such valuation is simply expressed, or denominated, in different currencies, and that valuation is not impacted by forward rates on foreign exchange.

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The Case for More than One Permitted Currency Denomination. At the March 14 Board meeting, there appeared to be unanimous agreement on a principle that stated that a share of common stock is not inherently denominated in *any* particular currency, including the currency of the exchange in which the shares are traded. One participant mentioned that a plot of land is not inherently denominated in any particular currency either, including the currency of the country in which that plot of land is located. In contrast to an equity share, a financial instrument such as an equity derivative must be denominated in a currency; for example, an equity option must denominate its fixed strike price in a currency. Given the principle that an equity share has no inherently “correct” currency denomination, we struggle to understand why the Board believes that Proposed Issue C21 must articulate a *single* currency as the *correct* currency for the denomination of an equity derivative instrument in order for it to remain on the path towards eligibility for equity classification through the application of paragraph 11(a) of Statement 133.

We believe that an equity derivative instrument should be denominated in *either* the issuer’s functional currency *or* the currency in which the investor is exchanging shares to be eligible for equity classification. Although the instruments in Examples 1 and 4 are dual indexed as described above and thus do not clear the EITF 01-6 hurdle, we do not object to the Board’s conclusion that the options in Examples 1 and 4 should not be considered dual indexed. As the Board has reasoned for these examples, there is a practical logic to considering the issuer’s perspective for determining whether the paragraph 11(a) exception (which is an issuer only exception) is available. We view the tentative decision reached for Examples 1 and 4 as an exception to the guidance in EITF 01-6, albeit an understandable exception, and one that is paralleled in the exception for non-financial instruments in paragraph 15 of Statement 133.

The exception that should be afforded the instruments in Examples 1 and 4 should not be extended to those in Examples 3 and 6. We agree with the Board’s decision regarding these instruments. For these options, currency *denominating* also constitutes an *indexing*. The option exercise price has been denominated in a currency that is neither the functional currency of the issuer nor the currency in which the shares referenced in the option contract are traded. In the instrument in Example 3, the strike price is denominated in Canadian dollars but shares trade in U.S. dollars, so the valuation of the option (and the investor’s exercise behavior) will be influenced by forward US\$/CAN\$ exchange rates, unlike the instruments in Examples 2 and 5. We believe this fact makes the instruments in Examples 3 and 6 similar to Instrument 4 in EITF 01-6, because the option’s settlement amount is based on both the movement of the company’s stock price and the movement of the forward foreign exchange rate. Furthermore, the instruments in Examples 3 and 6 illustrate what appears to be an intended embedding of an additional underlying into the contract that is extraneous from the viewpoints of both the issuer and the investor.

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There is Board precedent for an approach that respects the investor/holder's finance perspective in evaluating an option issuer's accounting as liability or equity. Footnote 19 of FASB Statement No. 123(R), "Share-Based Payment" ("Statement 123(R)") states:

"For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price *denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated* shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in Euros granted to employees of a U.S. entity's foreign operation whose functional currency is the Euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in Euros."

This footnote carried forward a principle previously established in Issue 31 of EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44," in which an employee stock option price was still viewed as "fixed" as long as the payment upon exercise was fixed in the currency of the primary economic environment of *either* the employer or the employee.

We believe that the Board should adopt our recommended approach for Proposed Issue C21, which achieves the same result as the comparable scenario for Statement 123(R).

Complexity Caused by Lack of Clarity of Issue C8. We agree that Issue C8 can be read to infer that the underlying principle creating a dual indexation to an entity's own stock and currency exchange rates is the denomination of an instrument's exercise price in a currency other than the issuer's functional currency. Such a principle would be consistent with the example in Issue C8. However, we believe that Issue C8 can *also* be read to infer that the underlying principle creating the dual indexation is the denomination of an instrument's exercise price in a currency other than the one in which the shares referenced in the contract trade. This principle is *also* consistent with the example in Issue C8. However, we believe that only this second interpretation of the underlying principle in Issue C8 is also consistent with EITF 01-6, which requires that the instrument's settlement amount be based solely on the issuer's stock. We believe that the requirement that an instrument's "settlement amount be based solely on the issuer's stock" means that investor exercise behavior cannot be influenced by any other underlyings and

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accordingly, the valuation model for that instrument cannot include the presence of any other underlyings, such as a forward foreign currency rate curve. Accordingly, we believe that only the instruments in Examples 2 and 5 from Proposed Issue C21 satisfy *both* the guidance in Issue C8 and that in EITF 01-6 in order not to be considered dual indexed.

In light of the failure of Issue C8 to clearly articulate the principle underlying what makes a derivative indexed to both an entity's own stock and to currency exchange rates, we recommend that a finalized Issue C21 *supersede* Issue C8. We believe that the removal of Issue C8 will make it easier for the Board to conclude that the instruments in Examples 1, 2, 4, and 5 are not dual indexed.

Denomination of the Consideration To Be Received by the Issuer Should Not Affect the Liability vs. Equity Evaluation. Proposed Issue C21 appears to be focused around the question of the denomination of the currency to be *received* by the issuer in order to determine whether an instrument is a liability or equity. Although not articulated in the Proposed Issue itself, we understand the Board and staff believe that because liability accounting necessarily involves a Statement 52 translation, the foreign currency translation risk associated with the possible receipt of non-functional currency consideration in the event the option is exercised will have been accounted for in the income statement if the option is required to be viewed as a liability. We find this logic concerning for several reasons. First, we question why liability accounting should be preordained because of the concern about the accounting for the potential future *receipt* of cash. Liabilities represent the probable future sacrifice, not receipt, of assets. We understand the staff may have been thinking about these options as if they were net cash settled, rather than gross physical settled, and that the net effect upon exercise could be a future sacrifice of non-functional currency cash. Our view is that EITF 00-19 will function as a second filter to capture those options for which cash settlement is out of the control of the issuer and will appropriately require liability accounting for such options. We see no reason to pre-empt the EITF 00-19 analysis prematurely and force liability accounting for even those options that would never involve the future sacrifice of non-functional currency cash. Second, as discussed above, changes in forward foreign currency rates have zero effect for the instruments in Examples 2 and 5 on whether or not there is ever any receipt of consideration to account for—that is, the “in the moneyness” of the options is solely a function of changes in the issuer's share price. Finally, a change in the functional currency of the issuer, which might occur with significant acquisitions or dispositions, could cause liability accounting to flip to equity accounting, or vice versa, based solely on the outcome of a Statement 52 exercise to evaluate the new functional currency of the issuer. This scenario, while not likely to be commonplace, nevertheless highlights the undesirability of constructing a liability vs. equity model that is dependent on an accounting construct in Statement 52.

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Summary of our Recommendations

1. Conclude that the instruments in Examples 3 and 6 are dual indexed and that those in Examples 2 and 5 are not dual indexed by grounding the definition of *indexing* in financial theory (e.g., option pricing theory), which we believe is true to the principle in EITF 01-6.
2. Conclude that notwithstanding financial theory, that the instruments in Examples 1 and 4 should not be viewed as dual indexed by permitting acknowledgement of the Statement 52 determination of the issuer's functional currency to overcome the result in #1 and by drawing on the principle that an equity share is not *inherently* denominated in any particular currency.
3. The result of combining our recommendations in points 1 and 2 is consistent with the result reached in Statement 123(R), footnote 19 for employee stock options.
4. Delete Statement 133 Implementation Issue C8, or else restrict its application only to the fact pattern described in its example in which the number of shares to be issued upon termination of the derivative is variable. Issue C21 focuses only on options to issue a *fixed* number of shares.
5. Remind the reader that the "no dual indexation" decision for Examples 1, 2, 4, and 5 is not in itself conclusive that the option contract is not a derivative under Statement 133. An analysis under EITF 00-19 might still conclude that such contracts are derivative liabilities. If a derivative liability conclusion is ultimately reached, Statement 52 shall be applied as necessary to translate the fair value of the derivative liability into the appropriate reporting currency (as would be necessary if the instruments in Examples 2 and 5 are determined to be derivatives under EITF 00-19).

We understand that some Board members believe that adding to the "DIG" literature increases the problem of complexity, and may not favor issuing any guidance in this area. We could not disagree more. The complexity problem in this particular topic lies with Issue C8, which does not adequately present the principle behind "indexing." We encourage the Board to delete and replace Issue C8 with the outcome of this project, even if that outcome does not reflect our recommendations, which will at least add clarity. If our recommendations are not accepted, we urge the staff to draft a stronger basis for conclusions so that readers can understand the Board's reasoning for departing from option pricing theory.

We have devoted a great deal of time to analyzing this issue and believe that the case for determining that the instruments in Examples 2 and 5 are *not* dual indexed is strong. Furthermore, we believe that analyzing Examples 2 and 5 from a financial theory point of view promotes the reduction of Statement 133 complexity, an objective which would make the U.S. financial markets more accessible to foreign domiciled companies. Accordingly, we would be pleased to discuss these issues in more detail with the Board or staff at your convenience either

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in person or by teleconference, and we would be happy to include our derivative valuation specialists in those discussions.

Sincerely,

Ernst & Young LLP