



December 4, 2006

Mr. Larry Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed FASB Staff Position No. EITF 00-19-b, "Accounting for Registration Payment Arrangements"

Dear Mr. Smith:

We appreciate the opportunity to comment on the abovementioned Proposed FASB Staff Position ("the Proposed FSP"). We support the issuance of the Proposed FSP in substantially its current form as we believe it will provide appropriate accounting and disclosure for registration payment arrangements and is generally consistent with our previous interpretation of the accounting for these arrangements. After a general comment, our comment letter contains observations and suggestions for additional improvements to the Proposed FSP.

General Comment

The registration rights agreement issue is a good example of a recurring challenge faced when evaluating whether various instruments, and especially embedded features in contracts, are derivatives under FASB Statement No. 133, Accounting for Derivatives Instruments and Hedging Activities. Specifically, the addition to the definition of an underlying of "the occurrence or nonoccurrence of a specified event" has called into question many contracts and features that include contingent payments. With a registration rights agreement, the trigger is a failure to file a registration statement and have it declared effective timely. Other examples of triggers for contingent payments may include non-performance or delayed performance or failure to meet specified criteria under contractual agreements, or terms that are triggered by events such as a change in control of the seller or issuer. In these examples, as with many others, the triggers for contingent payments are not purely financially-based but rather operationally or physically-based triggers. In many of these cases the triggers are primarily or even entirely within the control of one of the parties to the contract. In other cases, they may be outside the control of either party to the contract. However, a common element to these features is that they are generally not subject to any objective modeling techniques.

We believe the Statement 149 amendment of Statement 133 that added the concept of the occurrence or nonoccurrence of an event to the definition of an underlying, while generally sound in principle, has had some unintended consequences. For example, it may have scoped in features in contracts and instruments very similar to some of those that received exceptions under paragraph 10 of Statement 133. More specifically, it may have scoped in features very similar to those discussed in paragraph 10(e), which arguably could have been read to immediately scope some, but not all, of the non-financial triggers back out of Statement 133. In addition, as noted above, due to the lack of an objective modeling technique, these triggers present challenges in valuing the feature if bifurcation is required. We would encourage the Board and the FASB staff, at the appropriate time, to reconsider whether the occurrence or nonoccurrence of an observable event is a concept that is too broad, and whether the definition of an underlying can be refined in a way to better capture the events intended to trigger derivative accounting. Such an effort might also lead to the ability to remove some of the exceptions under Statement 133 by better articulating the principle of "an underlying." In the meantime, we encourage the Board to consider whether the guidance in paragraph 10(e) of Statement 133 provides further support for the Proposed FSP.

Specific Comments on the Proposed FSP

The following comments are generally organized by paragraph number in the Proposed FSP.

<u>Paragraph 6</u> - Although uncommon, there are instances where a registration payment arrangement references an external interest rate index in calculating the liquidated damages (for example, references "the 30 day LIBOR rate in effect as of the first day of the month"). A literal read of the guidance in paragraph 6 would suggest that such a feature was not within the scope of the Proposed FSP and thus would require further analysis for bifurcation. We agree with the concept expressed that excludes from the Proposed FSP a registration payment arrangement that referenced an external observable market or index as illustrated by the commodity price example. However, it would seem reasonable that reference to an interest rate index would be allowed provided there was no leverage involved in the calculation, as generally interest rate features without leverage are considered clearly and closely related to debt-like instruments.

<u>Paragraphs 7 through 9</u> — The Proposed FSP requires the measurement of the contingent liability for a registration payment arrangement under FASB Statement No. 5, *Accounting for Contingencies*. We believe that once the transfer of consideration under a registration payment arrangement becomes probable and reasonably estimable, it may extend for some time into the future, and in some cases could extend well beyond a year. Statement 5 does not discuss the application of discounting when measuring contingent liabilities. However, discounting may be applied in certain circumstances under a Statement 5 application, including certain long-term

insurance liabilities as well as certain environmental remediation liabilities.¹ When the transfer of consideration is expected to occur over a period of time, and especially on specific dates at specific amounts, we believe that discounting could be appropriate. We recommend providing a footnote or comment in the Basis for Conclusions that states the Proposed FSP does not address the issue of discounting contingent liabilities, so as to not necessarily preclude a preparer from discounting if considered appropriate.

<u>Paragraph 8</u>— The example in paragraph 8 of the allocation of proceeds to the initial contingent liability when the transfer of consideration is probable and reasonably estimable at inception seems to illustrate that the contingent liability receives its full allocation first, with the remaining proceeds allocated to the other instruments under other applicable GAAP. We question whether the FASB intends to indicate the registration payment arrangement would always receive its allocation first.

We note that in the example provided, none of the instruments are subject to subsequent fair value measurements, and believe this is intentional so as to avoid the issue that has emerged in practice since APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, (which was not amended by Statement 133 and did not contemplate that one of the instruments would require subsequent measurement at fair value) still requires a relative fair value allocation of proceeds to debt and separately issued warrants. We observe that absent additional guidance and amendments to existing guidance, and in recognition of the general fair value approach in Statement 133, in these circumstances practice has gravitated towards first allocating full fair value to those instruments in a basket issuance that are subsequently remeasured at fair value, followed by the allocation of proceeds to the remaining instruments on a relative fair value basis. We can foresee there will be cases where proceeds will need to be allocated to three items at issuance – a "historical cost instrument" (perhaps debt or an equityclassified instrument), a "fair value instrument" (a Statement 133 derivative or EITF 00-19 liability instrument), and a registration payment arrangement. We would recommend that the FASB provide definitive guidance in that case that the fair value instrument receive its full fair value, followed by the registration payment agreement and then the remaining instruments, as we believe that is consistent with current practice.

<u>Paragraphs 11 and 12</u> – Based on the commentary in paragraph B5 of the Basis for Conclusions, we question whether FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, should also be amended in recognition of situations where the registration payment arrangement is clearly a freestanding instrument, so that there is no question that the Statement 5 model is applicable rather than the Statement 150 model.

¹ As discussed in the AICPA's Audit and Accounting Guides for Life and Health Insurance Entities and Property and Liability Insurance Companies, and in AICPA Statement of Position 96-1, "Environmental Remediation Liabilities"

Paragraph 16 and 17 – The transition described in paragraph 16 where the carrying amounts for other instruments issued with the registration payment arrangement are not modified differs significantly from that required in paragraph 17 where a bifurcated derivative is recombined with its host contract. We believe that conceptually the better approach is as described in paragraph 17 and would involve recombining or recasting the transaction as of the issuance date, then reflecting the instruments at what would have been the carrying amounts as of the adoption date, and then recognizing the Statement 5 contingent liability. For example, in Example 5 in paragraph A12, the result of the adoption entries is a warrant that is not reflected at it issuance date fair value, and a net \$2 reflected in retained earnings that never initially went through earnings. The results from the transition provisions bear no relation to the actual issuance of the instrument. If the FASB retains the current dual approach in paragraphs 16 and 17, we recommend that the Basis for Conclusions discuss the rationale behind such an approach.

If the FASB retains the approach in paragraph 16, given the current guidance in Opinion 14 and potential diversity in practice in allocating proceeds to basket issuances (see our comment above on paragraph 8), there may be circumstances in which at inception an issuer allocated relative fair value to a "fair value instrument" at issuance rather than full fair value, then immediately adjusted the instrument to full fair value through a charge to earnings. In that case, reclassifying to equity the initial full fair value of that instrument as required in the Proposed FSP would, on a cumulative basis, "strand" the day-one immediate adjustment in retained earnings, or alternatively, result in a cumulative "initial allocation of proceeds" in excess of the actual proceeds. As an example:

Assume debt issued with a separate warrant where the total proceeds were \$100, the fair value of the debt was \$100 and the fair value of the warrant was \$10. Assume the warrant was carried as a liability under EITF Issue 00-19. Also assume the fair value of the warrant on the transition date for the Proposed FSP was \$12. If the issuer used a relative fair value allocation at issuance in accordance with Opinion 14, then debt was allocated \$90.91 (\$100 x \$100/\$110) and the warrant \$9.09 (\$10 x \$10/\$110). Immediately the warrant would have been marked to fair value of \$10, with a charge of \$0.91 to earnings. Subsequently \$2 would have been charged to earnings. On transition, as described in paragraph 16, the warrant liability would be debited for \$12, equity credited for \$10 (the fair value of the warrant on issuance) and the cumulative effect credited for \$2. However, that would make the "total allocated proceeds" (from both issuance and the adoption of the Proposed FSP) \$100.91 (\$90.91 + \$10), and "strand" a \$0.91 charge in retained earnings.

We believe the FASB should consider whether the situation described above merits consideration in the transition guidance.

Appendix A – Paragraph A2 – Example 1 includes a high end of the range of loss that represents a period that extends beyond one year, but does not illustrate the consideration of discounting. As discussed above in our comment on paragraphs 7 through 9, we believe the issue of discounting should either be addressed in some form in the FSP, or explicitly identified as not being addressed. As noted above, we believe that if the 18 month period was considered the best estimate, many preparers might conclude that discounting such an amount is appropriate.

<u>Appendix A - Paragraph A10 and following Examples</u> - In the transition examples, when applicable, we recommend noting for clarity that although the fair value of a separately recorded registration payment arrangement has increased over time, the probability of any related payment is still not probable.

Minor Technical Points on the Proposed FSP

The following are minor technical comments organized by paragraph number.

<u>Paragraph 5</u> - We would suggest "... instead of, <u>or in addition to</u>, obtaining and or/maintaining ..." as some instruments may invoke the registration statement for both a failure to obtain/maintain an effective registration statement as well as a failure to obtain/maintain a listing on an exchange.

<u>Appendix A – Paragraph A7</u> – This example appears to have a math error in that the amounts calculated for the range of loss are not adjusted for the fact the 50 basis point increase is per annum (implying division of the rate by 12) versus per month (as in paragraph A3 of Example 1).

<u>Appendix A – Examples 4 through 9 – To more clearly indicate the analysis of probability is based on the probability at the transition date, we would suggest editing the example titles to state "... Is Not (or Is) Probable at the Time of Adoption: ...".</u>

<u>Appendix A – Examples 6, 8 and 9 – In each of these examples, we would suggest the text be edited to read "the issuer determines that a \$X in payments under the registration payment arrangement is are probable."</u> As currently written in the singular, the example could give the impression only a single payment must be accrued at the time.

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We would be pleased to discuss these issues in more detail with the Board or staff at your convenience.

Sincerely,

Ernst + Young LLP