

Technical Directors

30 May 2008

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**Comments on:**  
**FASB Preliminary Views - *Financial Instruments with Characteristics of Equity* - File Reference No. 1550-100**  
**and**  
**IASB Discussion Paper - *Financial Instruments with Characteristics of Equity* - Invitation to Comment**

Dear Sirs:

The global organization of Ernst & Young appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB) Preliminary Views (PV) and the International Accounting Standards Board's (IASB) Discussion Paper (DP) documents, both titled *Financial Instruments with Characteristics of Equity*. In this period of increased focus on international convergence of accounting standards, the determination of which financial instruments should be classified as liabilities and which classified in equity by the issuer is an appropriate question to answer. That answer should essentially be the same across jurisdictions such that economically similar instruments are classified similarly. We commend the Boards for undertaking the effort to continue the FASB's decades-long project to resolve the issues associated with one of the most basic questions in accounting theory, and look forward to its completion in the future.

We strongly support the Boards' efforts in this area. Our general comments below are constructed around three themes. First, we believe that both Boards should undertake a joint, full-scale project to comprehensively consider the model for distinguishing between liabilities and equity as well as the related measurement and financial statement presentation issues. This project should begin at a conceptual level, such that any subsequent resulting standard is essentially implementation guidance for the concepts established. Second, if convergence in the short-term is considered of paramount importance by both Boards, and if this short-term convergence effort would be endangered by a broader, conceptually-based effort, then as part of an expedited project, we would tentatively support the Basic Ownership Approach from the three models described in the PV for various reasons, including its perceived simplicity. However, in the interest of short-term convergence, we also recommend that the Boards consider whether converging to some form of IAS 32, *Financial Instruments - Presentation*, (IAS 32) would

be appropriate as an intermediate step. Finally, if the IASB does not see an immediate need to engage in such a short-term convergence process with the FASB, then given the fragmented nature of the current US GAAP model, we encourage the FASB to unilaterally continue work on a Liabilities/Equity project, again both tentatively supporting the Basic Ownership Approach from the three presented and encouraging the FASB to consider some form of IAS 32 as an alternative model. However, we also believe that the IASB and FASB should then participate in a future joint project, again starting with a conceptual approach to defining liabilities and equity and culminating in a high-quality converged standard.

As the primary basis for both FASB and IASB documents is the FASB's PV, we will generally reference that document in our comments. Following our general comments are two appendices addressing the specific questions raised by the FASB (Attachment A) and the IASB (Attachment B) in their respective due process documents. In responding to the questions from the FASB, we focus primarily on current issues in US GAAP, or differences between current US GAAP and the proposed approaches. We do the same with the responses to the IASB, focusing on current issues in International Financial Reporting Standards (IFRS), or differences between current IFRS and the proposed approaches. However, given the FASB questions are more detailed, where appropriate we have included in the FASB responses some comments that derive from issues noted in jurisdictions currently applying IFRS. Throughout, we broadly refer to any effort to address liability and equity accounting as the Liabilities/Equity project.

We are submitting the comment letter simultaneously to both the FASB and the IASB. However, we are aware that in the future both standard setters may make significant decisions concerning their technical activity agendas or other projects that could affect the Liabilities/Equity project. As a result, we may have additional comments in the future based on decisions or actions subsequent to this letter.

## **GENERAL COMMENTS**

### **Importance of the Liabilities/Equity Project and a Conceptual Underpinning**

We believe the Liabilities/Equity project is a very significant and necessary undertaking by the Boards. It represents the possible paradigm shift that has been almost 20 years in the making, since the FASB released the 1990 Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both* (DM). We believe this project should be a comprehensive effort, free from pressures to finalize the project within compressed time constraints. The DP references the January 2008 publication, *Discussion Paper - Distinguishing between Liabilities and Equity*, released by the European Financial Reporting Advisory Group (EFRAG) and other national standard setters under the Pro-Active Accounting Activities in Europe (PAAinE) initiative. Paragraph ES.10 of that document indicates certain possible approaches "could not be implemented in [the] short- or even medium-term" and that "problems encountered under the current distinction principle require a response within a shorter timeframe." We believe that is a short-sighted view, which could have negative consequences to the long-term success of any standard that emerges from these efforts. There is a need for a comprehensive model for distinguishing liabilities and equity,

or reporting “claims” in the statement of financial position. The result of this effort is critical to improving financial reporting and should be expected to stand the test of time.

Perhaps as a next step in the process initiated by the DM, and as furthered by the 2003 release of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, the PV has moved directly into discussing specific models for determining which instruments should be considered equity. We believe it would be more appropriate to begin with a fresh conceptual view of equity. In the almost 20 years since the DM was issued, financial markets have grown deeper within countries and broader among countries, there has been explosive growth in the development of financing vehicles and instruments, and the dissemination of financial information has changed dramatically. An effort focused at the specific standard-level as currently contemplated in the PV may be misdirected without considering a broader context for improved financial reporting given the developments in the market.

In the 14 February 1992 response by our US firm (Ernst & Young LLP) to the DM, we advocated that “the current conceptual definitions of liabilities and equity be retained,” and that “removing the distinction between liabilities and equity would require redefining the current concept of income, which would needlessly require substantial user input and education.” However, this now seems to be a natural time to challenge the basic definitions of liabilities and equity and to make those substantial input and education efforts, given other current standard-setting initiatives. There are several ongoing projects that would be intrinsically associated with a Liabilities/Equity project. Two such significant projects are the Conceptual Framework and Financial Statement Presentation projects, which would logically represent fundamental building blocks to a conceptual-based Liabilities/Equity project. In combination, the Conceptual Framework, Financial Statement Presentation, and Liabilities/Equity projects could dramatically affect and improve the overall financial reporting model.

### **Consideration of the Conceptual Framework and Financial Statement Presentation Projects**

Determining the conceptual underpinnings for distinguishing between liabilities and equity seems a logical and necessary first step before addressing specific models in a standards-based project. Paragraph D22 of the PV notes that several standards-level projects addressing current practice issues must be addressed before that conceptual framework project can be completed. It states that, “The conceptual framework project will address differences created by the standards-level project.” We believe there should first be a consistent underlying theory for determining which “credits” in the balance sheet are classified as liabilities and which are classified as equity, and a consistent underlying theory as to how those “credits” are subsequently measured. We believe that moving directly to a standards-level project for such a significant conceptual issue can lead to challenging implementation issues later on and in some cases may lead to unintended consequences or remorse over results of the application of a standard.

For example, in the 7 September 2004 response from our US firm to the FASB on the Proposed Statement of Financial Accounting Standards, *Fair Value Measurements*, we encouraged the FASB to first consider the conceptual underpinnings and application of fair value measurements, expressing concerns related to applying fair value

measurements in certain situations. However, the FASB decided to go directly into a standards-level project. Currently, we have a standard in FASB Statement No. 157, *Fair Value Measurements*, for which application has been deferred for non-financial assets and liabilities and for which the FASB is debating exactly how it should be applied to financial liabilities. These issues could have perhaps been avoided (or at least anticipated and addressed in Statement 157) if a conceptual-based approach had been taken at the outset of the project. In contrast, the IASB is beginning its fair value measurements project with a more conceptual focus, as we encouraged in our global organization's 4 May 2007 response to the IASB's Invitation to Comment - Discussion Paper "Fair Value Measurements." Further, we believe the Boards may be faced with issues not dissimilar from those being confronted in the revenue recognition model, where the Boards have agreed that a conceptual approach is the appropriate first step.

The need to consider the underlying conceptual approach in the Liabilities/Equity project is provided within the Conceptual Framework project itself. To date in the joint project, as confirmed at the April 2008 joint meeting, the Boards have tentatively concluded that the *entity perspective* should be adopted regarding the objective of financial reporting. The entity perspective is intended to convey that an entity, not its owners and others having an interest in it, is the object of general purpose financial reporting. It would seem to us that all of the various models proposed in the PV are not consistent with that premise to some degree. For example, the Basic Ownership Approach seems to be a *proprietary perspective*-based model as it focuses solely on reporting the most residual claims as equity to those holders. While the PV tries to explain in paragraph 60 that the difference between an entity perspective and proprietary perspective can be considered to primarily address *how* information should be reported in financial statements rather than *where*, we fail to see the relevance of that explanation. We would argue that *how* information is reported is a critical element in determining what is classified as a liability versus equity, and how those instruments are measured. We believe this further indicates the wisdom of completing the conceptual basis for the distinctions between liabilities and equity first.

As another example, in defining a basic ownership interest (as used throughout the PV), the focus is on the most residual interest as regards liquidation. Given all the potential characteristics of an instrument (e.g., voting rights, dividend rights, protective rights, liquidation preferences), we could envision various combinations of rights, or absence of rights, that could lead one to consider Instrument A to be "subordinated" or "residual" to Instrument B in a going-concern context, even if Instrument B was structurally subordinated in liquidation. The breadth of possible rights included in or excluded from an instrument, and what should constitute a "residual," seem to represent key conceptual issues that we believe would be best addressed in a conceptual-based project.

A final example of the need for a conceptual approach is found in defining the actual scope of a final standard. As drafted, paragraph 15 restricts the scope of the project to basic ownership interests (as later defined) regardless of legal form, other instruments that are ownership interests in legal form, and other contracts that are settled with basic ownership instruments or whose fair value is determined by prices of basic ownership instruments. We believe it is inappropriate to refer to the legal form of ownership interest in a standard with global application because of the considerable differences in legal terminology and requirements in different jurisdictions. While paragraphs 22-24 appear to be a principles-based approach to address differences in legal environments, we question

why the premise of “legal form” is necessary. If the characteristics of “legal form” ownership instruments in the US are not already reflected in the criteria applied in the PV, then those characteristics should be clearly articulated in the literature, rather than relying on a construct focused on the form in the US legal environment. Clearly articulating the concept would allow any reference to legal form to be deleted. Said differently, if the FASB believes that the existence of certain rights in US “legal form” equity, or perhaps the absence of certain rights (e.g., absence of creditor rights), is necessary for equity classification to even be considered, then those characteristics, or lack thereof, should be clearly articulated. We also question if the concept of a “proprietary interest” in paragraph 23 is universally understood in a manner to promote consistent application. These again are conceptual issues.

For liabilities and equity instruments, while classification in the statement of financial position is important, presentation in a statement of financial performance is often the primary focal point. How and where to show any changes in the measurement of liabilities or equity items will be of great interest to many of the Boards' constituents, especially preparers and users. The topic of financial statement presentation is being addressed currently in the joint Financial Statement Presentation project. One element of Phase B in that project addresses defining the totals and subtotals to be reported in each financial statement (to potentially include categories such as business and financing). In reaching conclusions on the Liabilities/Equity project, it would seem critical to understand related decisions on the form and content of financial statements, and especially the various possibilities for a meaningful presentation of the changes in these contracts in a statement of financial performance.

***Based on the above discussion, we believe that the FASB and IASB should undertake a joint, broadly-scoped Liabilities/Equity project to comprehensively consider the models for the distinctions between potential liability and equity instruments, as well as the related measurement and financial statement presentation issues. We believe this process should start with a conceptual underpinning of what it means to be "equity." Therefore, we recommend completion of the relevant components of the Conceptual Framework project in this area first, rather than creating a standard and reverse-engineering the framework. This process should also include consideration of other broad conceptual projects with implications for the reporting of liability and equity contracts and changes in those contracts, including the Financial Statement Presentation project. Once the conceptual phase of this project is completed, with the distinctions between liabilities and equity determined and a framework for reporting those instruments and changes in those instruments established, an analysis of the possible models that would serve as implementation guidance for those concepts would be appropriate. This effort would include analyzing any models currently proposed by the FASB that remained viable in light of the conceptual framework, as well as any models identified or developed by the IASB. Since "equity here" should be "equity there," we believe the insight of the IASB into the various issues associated with differing geo-political constructs, legal systems, and capital structures is critical in selecting an appropriate model to be utilized in any internationally-accepted standard.***

### Short-Term Convergence Focus

At this time, most of the members of the financial reporting community are focused on the hope for a single set of high quality international accounting standards in the future. Various standard setters, securities regulators and other relevant groups have made convergence efforts a priority in the last several years. However, one area that is not converged is the area of liability and equity accounting. Further, no real convergence efforts in this area have been made to date. This is due to the nature of the existing differences between US GAAP and IFRS, which do not lend themselves easily to short-term convergence efforts. The Liabilities/Equity project represents the best opportunity for convergence in this area.

***If convergence in the short-term for liability and equity financial instruments is considered of paramount importance to both Boards, and if this short-term convergence effort would be endangered by the broader, conceptual-based project advocated above, then we would tentatively support the adoption of the Basic Ownership Approach from the three models described in the PV for various reasons, including its perceived simplicity. However, this tentative support is conditional on gaining a better understanding of the comprehensive model, including subsequent measurement issues and financial statement presentation issues. Further, and again in the interest of short-term convergence, we also recommend that the Boards consider whether converging to some form of IAS 32 would be more appropriate.***

In suggesting the consideration of IAS 32 for short-term convergence, we acknowledge that those currently applying IFRS find numerous faults with that model. Many of these are highlighted by the IASB itself in the DP. Therefore, the Boards could consider several possibilities for adoption of IAS 32 as an interim measure. First, IAS 32 could be adopted "as-is," with its existing flaws and issues. Secondly, simple modifications or improvements could be considered for IFRS, with US GAAP adopting the entirety of the modified version. Finally, a more expansive amendment of the standard could be undertaken, in which the basic model was not changed but the more complex existing issues were addressed. In all three scenarios, US GAAP entities would be adopting a new standard in its entirety, while the impact on IFRS entities would vary based on the extent of any changes to the existing IAS 32.

### Current US GAAP Model

Comprised of standards that were promulgated over a period spanning more than 50 years, the current US GAAP model for liability and equity accounting is almost unworkable. The relevant standards and interpretative guidance are from periods that have seen the move from historical cost accounting concepts to the introduction of accretion and time value of money concepts, then to the introduction of option pricing models, and finally to full fair value accounting. As a result, there are numerous bases for initially and subsequently measuring liability and equity instruments and components (e.g., historical cost, accreted value, intrinsic value, and fair value). There are numerous models for accounting for the derecognition of these instruments (e.g., maturity, early settlement, conversion, induced conversion, modification, and extinguishment). Just determining whether an instrument is a liability or an equity instrument (or has a

component to be separately accounted for as either a liability or equity) is extremely challenging. According to a study by Audit Analytics, issues related to "Debt, Quasi-Debt, Warrants and Equity (BCF) Security Issues" were the leading cause or a contributing cause to more restatements than any other issue for the three-year period 2005-2007, and among the top four leading causes or contributing causes for the four-year period 2001-2004.<sup>1</sup>

The need for a US GAAP model that is easier to understand by the entire financial reporting community, and easier to apply by preparers, is irrefutable. Interim steps have been taken, such as Statement 150, but most of the standard-setting activities have been temporary fixes or interpretive guidance to address immediate issues, as is often the case with Emerging Issues Task Force consensuses. The Liabilities/Equity project represents the culmination of the FASB's efforts to comprehensively address the problems. However, notwithstanding the areas of concern in the IASB's DP, it is not as apparent that IAS 32 is as desperately in need of immediate reconsideration as the US GAAP model. It could be that the IASB does not feel as strongly compelled to engage in the Liabilities/Equity project at this time.

***If the IASB does not see an immediate need to engage in a short-term convergence process, then given the fragmented nature of the current US GAAP model, we encourage the FASB to unilaterally continue work on the project. For the reasons already noted above, and with the same caveats, we would again tentatively support the adoption of the Basic Ownership Approach from the three models presented. Consistent with our comments on short-term convergence, we would also recommend the FASB at least consider unilaterally adopting some form of the IAS 32 model as an interim standard.***

Similar to the discussion under short-term convergence, the FASB could at least consider adopting IAS 32 as an interim standard. The FASB would have the same three alternatives for adoption discussed above. We do not believe the FASB would have to feel constrained to only adopt IAS 32 as currently promulgated, as any improvements would provide additional information for a future comprehensive project by both Boards to revisit liabilities and equity accounting. In addition, even if the FASB considered and adopted a form of IAS 32 different from current IFRS, it would still represent a significant step towards convergence in the short term.

However, at some point in the future, for the sake of convergence and the adoption of the highest quality international accounting standards, this would be an area that would require the focus and resources of the IASB. We also believe that the FASB would then need to participate jointly in any project to result in a high-quality converged standard, even if it means there would be a relatively short period between first adopting a "new" US GAAP model and then adopting a "new" internationally-converged model (if different).

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<sup>1</sup> Audit Analytics February 2008 Briefing: 2007 Financial Restatements - A Seven Year Comparison

### **Qualified Support for the Basic Ownership Approach**

As noted above, we strongly support a broadly-scoped Liabilities/Equity project to comprehensively consider the conceptual underpinnings and various models for the distinctions between potential liability and equity instruments, as well as the related measurement and financial statement presentation issues. However, we would tentatively support the Basic Ownership Approach over the other models currently proposed in the PV if such a comprehensive project is not feasible either jointly by the FASB and IASB, or individually by the FASB. Our tentative support for the Basic Ownership Approach is predominantly based on its relative simplicity with regard to the initial classification of financial instruments. In terms of simplicity versus complexity, it is certainly a quantum leap from the complexity inherent in the current US GAAP model, and also generally simpler than the current IFRS model. We also believe that it represents at least some form of principled response to the question of what constitutes equity – that is, the most residual claim (or claims) are classified as equity. However, while we could support the Basic Ownership Approach, that support is contingent on several factors that include fully understanding the complete model and its effect on other standards.

For example, to fully understand the model, we are interested in understanding how operable the basic principle would be in practice for various legal forms of entities, such as partnerships, real estate concerns, or other forms of collective investment funds, where there may be several forms of “residual” equity that share returns based on various percentages in various layers or under differing scenarios. Likewise, we question how the model would be applied to certain instruments issued by entities in jurisdictions where dividends, while not contractual, may be required by statute and can be waived only by a vote of the shareholders. Field testing the approach against instruments and ownership/corporate structures in non-US jurisdictions would be important. Finally, we believe many will be interested in understanding future conclusions on how perpetual instruments classified as liabilities would be measured and presented in a statement of financial performance under the Basic Ownership Approach.

Further, it is challenging to formulate views on a given model (or, in fact, three models) in a relatively narrowly focused document when there are so many unanswered questions. A full understanding of any model, including the Basic Ownership Approach, requires an understanding of the interaction of that model with other existing standards. In addition to those general issues above related to the conceptual framework and general financial statement presentation, the following are some of the unanswered questions that are more standard-specific (and would need to be considered in fully evaluating any of the three approaches in the PV):

- Will the distinctions between liabilities and equity make sense in a wide variety of capital structures and business forms, with results that are meaningful to investors? For example, what about applications to partnerships and the various allocations that can occur between general partners and limited partners?
- Will the definitions make sense in a wide variety of industries? For example, what about differences between manufacturing companies, where an instrument subject to liability/equity classification is usually a means of financing, whereas the same instrument may have more of an operational character for a financial institution?

- Will distinctions as liabilities and equity be made consistent across existing standards? If so, under US GAAP for example, how would that effect:
  - FASB Interpretation No. 46 (R), *Consolidation of Variable Interest Entities an interpretation of ARB No. 51*, and the determination of whether there is sufficient equity at risk? Will it have unintended consequences on consolidation policy?
  - The concept of the “host instrument” under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*? Would the concept of bifurcation still be relevant under whichever model was selected?
  - An investor’s classification and accounting as a holder of an instrument under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Instruments*?
- How will the separation and linkage concepts interact with existing standards, such as Statement 133?
- How will the classification and measurement concepts interact with the existing (or potentially modified) calculations under FASB Statement No. 128, *Earnings per Share*?
- Will the use of a proprietary model be reconciled across other standards? For example, what about the recent business combination standards that took an entity perspective for the consolidated reporting rather than a proprietary perspective for reporting noncontrolling interests?
- Will the model be consistent for all instruments that are within its scope? For example, will instruments issued to employees and others as compensation be classified, measured and presented in a similar manner?
- Will an improved classification model be offset by the complexity of the measurement and valuation issues, especially for private entities? What is the net result of such a cost/benefit analysis?
- In defining equity under the Basic Ownership Approach (or any other model selected for that matter), it will be important to consider whether instruments not found to be equity are adequately addressed in the remaining literature for liabilities. This would include ensuring that the scope of other standards that rely on the definition of a “financial liability” or “financial asset” adequately embrace the full range of instruments that are not classified in equity.

### **Consideration of Investors’ Perspectives and any Broader Effects on Markets**

We believe that in evaluating any potential outcomes of the Liabilities/Equity project, regardless of whether it is a full scope or an expedited project, the considerations of users of the financial statements, as the ultimate consumer of external financial reporting, is of paramount importance. Also, the effects on the broader financial markets, including the potential for unintended consequences, should be considered.

A key consideration to reaching any final conclusions on any approach should be the needs of investors and other users of financial statements. The ultimate litmus test for success will be whether users will find the financial statements more useful (i.e., improved transparency, simpler to understand, consistent presentations and classifications among entities, and clear presentation of the economics). Said differently, will the results of the selected model facilitate or inhibit an investor’s efforts to project future income potential, or assess the ability to repay obligations as they come due?

Analysts generally claim to want to see the volatility in the financial statements from exposures to market risks, but we question whether that holds true for exposures to the entity's own equity prices. Perhaps if all assets and liabilities appeared on the balance sheet and were measured at fair value, then marking a instrument tied to the value of the entity's "equity" to fair value would not produce the unusual results that occur when there are mixed models for measuring assets and liabilities, and some assets (e.g., internally-generated intangibles) or liabilities (e.g., non-probable contingencies) are "missing" from the statement of financial position. For example, in the case of a company having relatively little equity but many equity-related "liabilities" marked to fair value through earnings (for example, written call options), in the period the fair value of the company's equity increase dramatically, reported equity could actually become negative. We question whether analysts and users would find this useful information, and believe an understanding of the user's needs is critical. If the efforts of the Boards result in a standard that produces financial statements that must be adjusted by the user community to remove the effects of the standard when performing their financial analyses, then the standard would merely be raising the cost of compliance, and thus the cost of capital, by requiring information that was not wanted or used.

Even today, analysts and rating agencies evaluate specific instruments in a company's capital structure and allocate them in debt/equity ratios and other analyses based on the characteristics of liabilities and equity, rather than retaining them as single instruments, and rather than respecting the geography/classification determined under GAAP. A successful result to the Liabilities/Equity project could be a reporting model that does not require such adjustments by analysts as an indicator of investor acceptance and recognition of the usefulness of the information provided.

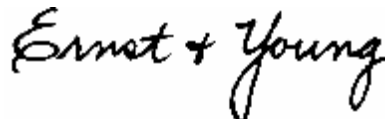
In considering any broader effects on the markets, it must be acknowledged that accounting often affects the underlying business decisions of an entity. While we agree that neutrality is an important concept in standard setting, standard setting should not be done in a vacuum. Volatility is a chief concern among preparers and often adjusted out by users. This will place added pressure on the measurement bases for instruments ultimately concluded to be liabilities. There is always the risk that certain instruments that are desired by the market (either by issuers for cost-efficient financing or by investors for investment purposes) are eliminated by virtue of "undesirable accounting." The Financial Statement Presentation project has the ability to minimize any issues here by considering a meaningful presentation of the subsequent measurements of these instruments, especially those to be classified as liabilities and measured at fair value. We hope that the Liabilities/Equity project would not result in the extinction of instruments representing the various economic risks and rewards that are desired by both investors and issuers due to financial reporting concerns that could be appropriately mitigated.

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In conclusion, we strongly encourage both Boards to take an opportunity, and perhaps a longer-term view of the project, to comprehensively analyze the issues related to classification, measurement, and presentation of liabilities and equity. A conceptual-based approach, such as through the Conceptual Framework project, should be used to determine the direction of standard setting, not the reverse. The Liabilities/Equity project, conducted in an orderly manner, offers a tremendous opportunity for a paradigm shift that could result in improved financial reporting across the world.

We would be pleased to discuss our comments further with the Boards at your convenience. Please contact either Leo van der Tas (Netherlands - Rotterdam, +31 10 4068144) or David Holman (United States - New York, +1 212 773 2326).

Sincerely,

A handwritten signature in cursive script that reads 'Ernst + Young'.

Attachments:

- A - Responses to Specific Questions in FASB Preliminary Views (pages 1-17)
- B - Responses to Specific Questions in IASB Discussion Paper (pages 1-4)

**ATTACHMENT A  
RESPONSES TO SPECIFIC QUESTIONS IN FASB PRELIMINARY VIEWS**

**QUESTIONS ON THE BASIC OWNERSHIP APPROACH**

*1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?*

We generally agree the Basic Ownership Approach would make financial reporting simpler, especially as it relates to classification under the current US GAAP model, and as a result many would say it would be an improvement. The underlying principle is clear, but the appropriateness of that principle and the practicality of its application remain to be seen in context of broader financial reporting projects.

However, the focus on “simplicity” raises basic conceptual questions about what it means to make financial reporting “simple.” For example, is it a principle role of the standard setter to make the guidance easy to apply? We believe the users of the financial statements should have some ability and responsibility to critically evaluate the information they believe is necessary in making business decisions as an owner, creditor, supplier, customer, or through any other relationship. Also, while simplifying the initial classification of these instruments, does it just shift the complexity to the subsequent measurement and valuation of the underlying instruments? Assuming that, as proposed, the Basic Ownership Approach will require more of these instruments to be subsequently measured at fair value, then the complexity and other issues the FASB is currently struggling with in the context of proposed FASB Staff Position FAS 157-c, *Measuring Liabilities under FASB Statement No. 157*, (FSP FAS 157-c) will be confronted more frequently in practice. If there was a different character among balances reflected as liabilities (e.g., some cash settled, some share settled, some perpetual and perhaps actually never to be settled), then is the complexity shifted to the difficulty of finding an appropriate presentation and related disclosures in order to provide the information needed by the investor when considering each different “type” of liability? Finally, are other currently “simple” models made more complex, such as how to apply treasury stock accounting to legal-form common equity that was not classified as equity because it was not the ultimate residual (is that extinguishing a liability?), or accounting for stock splits and stock dividends on instruments that were legal-form equity but no longer classified in equity?

The Basic Ownership Approach would seem to generally minimize structuring opportunities. However, given the initial conclusion that the classification in a subsidiary's or consolidated variable interest entity's standalone financial statements would generally survive in consolidation, we are concerned about potential unforeseen structuring opportunities. For example, if more equity is needed, can a subsidiary or other consolidated entity be created to provide

additional “equity” that would not represent a residual interest on a consolidated basis? As a specific example, assume a Parent needs more equity. It creates a Subsidiary that issues a single class of equity that is purchased 51% by the Parent and 49% by outside investors (minority interest holders). The Subsidiary then loans all the proceeds back to the Parent on a subordinated basis. The holders of the Subsidiary’s equity, which presumably is equity for the consolidated entity, would in substance really only hold a note issued by the Parent on a consolidated basis. In addition, we note that the initial conclusion on basic ownership interests issued by subsidiaries or consolidated variable interest entities would seem to violate the proprietary perspective underlying the definition of equity in the financial statements of the consolidated reporting entity.

Finally, a key question is whether the Basic Ownership Approach would be viewed by users as an improvement to financial reporting despite its simplicity. With a proprietary perspective, rather than an entity perspective, it is not clear whether that model will satisfy the needs of creditors and other users as the FASB asserts in paragraph 61, stating “classifying only basic ownership interests as equity actually better serves all classes of stakeholders.” The FASB has not provided a rationale for that statement.

As discussed in the general comment letter (and in question B2 in Attachment B), from a conceptual and international perspective, we question whether the focus on “ownership interests in legal form” in paragraph 15, as further discussed in paragraphs 22-24, suggests that some characteristics inherent in, or absent from, legal-form equity would better be reflected as criteria for equity classification rather than a scoping issue.

### ***Perpetual Instruments***

*2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?*

We do not believe there is necessarily an “operational” concern with presenting perpetual instruments as liabilities. However, users and others may be puzzled by a result that shows a redeemable instrument as equity and a perpetual instrument as a liability, regardless of the redemption amount for the redeemable instrument. As creditors look to using the financial statements, it would seem that perpetual instruments, such as preferred stock with a liquidation preference that is legally subordinated to debt, are not relevant “liabilities” from their perspective given a going-concern notion and the lack of creditor rights holders of such legal form equity instruments would possess in bankruptcy. Therefore, the associated disclosures would need to be evaluated to make sure the user understands the distinctions and potential future cash flows associated with such a liability. This also illustrates another potential issue to be considered when evaluating whether to

ultimately support the use of the proprietary model of reporting. That is, would an entity's perspective of its economic obligations that considers perpetual instruments as truly perpetual (and not due to be settled as most liabilities are) be more representative?

*3. The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.*

Of the three methods presented (essentially no remeasurement, a fair value method, or a discounted cash flow method), we would currently prefer that these liabilities not be remeasured, with dividends reported as expenses when they are declared and/or legally become an obligation of the issuer. We see at least one common issue with the remaining two alternatives, that being the need for potentially very subjective estimates for future dividend rates and future liquidation dates or "deemed liquidation" events. While clearly these inputs are necessary for a discounted cash flow method, they would also be necessary for a fair value method if the instrument (or a similar instrument) was not traded with a quoted price. The fair value method would also raise issues similar to those in the FASB's proposed FSP FAS 157-c.

There may be other methods that could be explored, such as something akin to hypothetical liquidation at book value for perpetual instruments with no dividend requirements. However, for instruments with dividends that are contractually required or expected to be paid, focusing solely on a possible liquidation settlement amount would seem to inappropriately ignore the future dividends. As another alternative, which may be appropriate for those instruments and would be a variation on the discounted cash flow model briefly noted in paragraph 34(c), a discounted cash flow model could be used but using the historic discount rate (market rate at date of issuance) or contractual dividend rate rather than a then-current market rate at each measurement date. Under that model, the instrument would only be remeasured to reflect changing expectations of the life of the instrument, rather than volatility that would be associated with changes in market rates.

#### ***Redeemable Basic Ownership Instruments***

*4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?*

We believe the guidance in paragraph 20 will lead to further implementation questions as currently drafted. As a result, we are concerned the guidance may not be operational.

For example, for an entity that is highly leveraged or perhaps has a significant amount of preferred stock outstanding, fair value of the redeemable basic ownership interest may be very different from the liquidation value. Also, we question under paragraph 21(a) whether a formula can truly be designed to approximate the fair value of the instrument and anticipate future changes in circumstances (e.g., operations, earnings, capital structure) that could affect the fair value and/or redemption amount. For example, a common formula for redeemable instruments uses a fixed multiple of earnings (or other similar measure) to derive the redemption value. As it is likely that the appropriate multiple to estimate the fair value of the instrument would change over time, it would seem that such a formula may not result in an approximate fair value of the instrument. However, even if a variable, market-driven multiple was used, if a significant product liability suit was filed the day before the valuation under the formula, the effect of that event would dramatically affect the fair value of the entity and the instrument, but not the historical earnings basis for the formula. Finally, it is not clear whether the formula would have to be expected to *always* work, or just *usually* work (for example, in the absence of “unusual” events)?

In paragraph 20(b), the meaning of “impair the claims of any other instruments with higher priority” is not entirely clear to us. Once assets have been utilized to redeem the instrument, they are no longer available for other purposes, thus in essence “impairing” the future claims (reducing assets available) for those investors with higher priority that might come due later. Is this impairment test conducted at each reporting date based only on current facts and circumstances (such as a presumed redemption/settlement of all instruments on that date)? What tests would be acceptable to determine there would be no “impairment” (e.g., passing a solvency test both before and after an assumed redemption)? Also, presumably there would have to be some explicit terms in the redeemable instrument preventing such “impairment,” because without any explicit terms, the criteria could literally not be met. Would those terms have to protect against “impairment” in all possible scenarios (similar to the “theoretically possible” standard some regulators have followed in equity classification decisions relative to the ability to settle a contract in shares) or, alternatively, only under the “reasonably expected” scenarios?

### **Separation**

*5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board’s understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?*

It would be important to distinguish which dividends are being addressed here and what is meant by a “required dividend payment.” In our experience, even fixed-rate dividends on a preferred stock instrument only become a true legal obligation when and if declared, and the ability to declare dividends is dependent on jurisdictional law. We believe this may also be the case for dividends that are cumulative if not declared. Such dividends cannot be forced upon the company unless applicable jurisdictional laws are met, allowing their payment. In fact, we understand this is the case for the redemption or liquidation amounts for “redeemable” preferred stocks where redemption is outside the control of the company. Once again, such redemption amounts cannot be settled unless allowed under the law. We have been told that preferred shareholders, even those holding mandatorily redeemable preferred shares, generally do not have creditor rights and must pursue any remedies under corporate law. While the model requires presentation of the dividend amount as a liability, we do note that it may not reconcile with an entity’s legal liability. Likewise, we question how separation would be applied to certain instruments issued by entities in jurisdictions where dividends, while not contractual, may be required by statute and can be waived only by a vote of the shareholders. Are the shareholders associated with “the entity” such that the entity does have the discretion to avoid the dividend? (See also question B3 in Attachment B.)

The separation guidance also raises measurement and presentation questions. For example, if an instrument is redeemable at fair value and qualifies as a basic ownership interest, yet has a “required” dividend, then it is possible that under some measurement alternatives the dividend liability could result in a large component, and possibly the entirety of, the instrument being presented as a liability rather than in equity when separated into the two components. Also, it is not entirely clear to us what would be the effect of changes in estimates on length of dividend payments. For example, would it adjust the carrying amount or accretion of the liability through earnings, or rather result in a reallocation between the dividend liability component and the equity component, if any. It is also not clear to us how ultimate redemption of this amount would be reflected under paragraph 49.

The usefulness of the information would depend on answers to the above questions, but generally we would agree that providing information on the dividend requirement and likelihood of the timing and amounts of dividend payments would be useful.

### **Substance**

*6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument’s classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there*

*factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?*

It is difficult to deal with substance without directly dealing with the concept of economic compulsion. Economic compulsion seems to be an ever-present factor that is not part of the stated terms of a contract and would need to be considered under the "substance" guidance as presented. This is likely more important under the Ownership-Settlement Approach, but could be relevant under the Basic Ownership Approach. For example, assume an entity issues an instrument redeemable by either the holder or the issuer at fair value. Further assume that the instrument's terms do not permit the payment of dividends to any other instruments until it has been redeemed. While it would appear this instrument qualifies as a redeemable basic ownership interest, there could in substance be an economically compelling reason for the issuer to redeem the instrument as a result of the dividend restriction. How would such an instrument be considered in light of the guidance on substance?

As another perspective on substance, we question whether the proposed guidance would address a situation where an insignificant amount of a more "residual" instrument would be considered substantive. At the extreme, assume an entity issues a trivial amount of an instrument that has an even lower standing in liquidation than common stock. While literally now being the most residual class, given its relative immateriality, should it force all other instruments to become liabilities? We believe in some jurisdictions, the concept of a "deferred share" is a legal construct that may be a remnant of a past transaction that technically is subordinated to the common shares, but under the Basic Ownership Approach might drive the common stock to be a liability unless the entire issuance of "deferred shares" was considered nonsubstantive.

### **Linkage**

*7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?*

It is difficult to conclude on the economic effect of linkage without understanding how existing guidance might be modified to accommodate that concept. While linkage is intended to prevent abuses by not allowing two instruments to be accounted for differently than would a single instrument with the same economics, Statement 133 historically has the opposite concern as to a) the inappropriateness of synthetic accounting for two instruments and b) the inappropriateness of embedded features avoiding derivative accounting. There is a natural tension between linkage and separation, and it is not clear what the general philosophy would be relative to the current bifurcation and hedging models under Statement 133. For example, if two instruments were issued with the same counterparty at the

same time (floating-rate convertible debt and a pay-fixed/receive-floating interest rate swap), would the issuer have to combine the instruments and account for the combined instrument as fixed-rate convertible debt? That would seem to violate the concepts in Statement 133 on synthetic accounting. If linked, would that instrument then perhaps also have to be separated into a liability component (fixed-rate debt) and an equity component (conversion option)? That would seem to challenge any conclusions on separation. Assuming the applicability of the linkage guidance as drafted is limited to only those instruments that would need to be evaluated under the liability/equity model for classification, then could terms of a structured transaction be allocated between one instrument within the liability/equity model and one outside the model to avoid the linkage criteria for the two in combination?

As for the guidance provided, we note a potential change in practice in that paragraph 41(b) is intended to capture all scenarios where the reported net income or equity would be different. Historically, in various anti-accounting abuse models, such as linkage, the bias has been towards favoring an outcome that results in more fair value accounting and the associated volatility. But as drafted, the existence of any "different" net income or equity could trigger linked accounting that could result in the elimination of fair value accounting for some combinations. For example, if a combination of convertible debt and a purchased call option would result in synthetic nonconvertible debt, then those instruments would potentially be combined to result in traditional amortized cost debt accounting rather than separate fair value accounting for at least a component of the transaction, because literally the net income is different (albeit smoother) under the combined account than the separate accounting. Does this represent a potential change in the historical bias towards fair value accounting?

We also question whether the guidance in 43(b) will be operational as regards the criteria on "achiev[ing] an overall economic outcome that could have been achieved as simply or more simply with a single instrument." When complex financial instruments are decomposed into their component single instruments, the pricing (and actual economics) can be different for several reasons. Thus, a separated structure (two instruments) may not literally provide the same overall economic outcome as a single instrument. Examples of this would be various "unit structures" that typically consist of debt issued as a package with separate options or forward contracts. If the economics of the combined transaction is not literally the same as the individual transactions, presumably one could argue that linking the transactions is not required. In this case, while each of these instruments may be liabilities under Basic Ownership Approach, the measurement attributes may be different.

Finally, we question if there should be some element of intent in the criteria in paragraph 43. Paragraph 41(a) as currently drafted requires that two transactions be part of the same arrangement to consider linkage. To determine if they are part of the same arrangement, paragraph 43 provides an "if at least one of the following conditions exist" test, meaning if the instruments were issued at or near the same

time with the same or related counterparty (the condition under paragraph 43(b)), then the two instruments would be deemed part of the same arrangement. However, given the breadth of operations of some entities, we can foresee entities with multiple operations or multiple trading desks facing a hardship in evaluating this criterion, and perhaps arriving at inappropriate linkages. For example, assume a financial institution with multiple trading desks has a client with multiple operations. On the same day, the entities execute one transaction between Desk A of the bank and Division A of the counterparty and a second transaction between Desk B of the bank and Division B of the same counterparty. While there may never have been any contemplation of the two transactions together by either party, it would seem that paragraph 43(b) would require each of those entities to review all their transactions on that day, discover these two, and consider them as one arrangement. That results because there is no "intent" notion in the linkage guidance as drafted, but simply a same time/same counterparty criterion.

We would strongly recommend broad field testing of any linkage guidance to a wide variety of transactions, but only after concluding on an initial conceptual basis as to when to combine and when to separate.

Regarding the specific example in the PV, we found it to be unclear relative to the guidance in paragraphs 41 and 43. Likely these are just drafting issues that could be easily addressed. The example states the issuer "has" shares outstanding on 12/31/X1 and then "issues" put options on those shares at a fixed strike price on 1/1/X2. The narrative then states they were "issued at about the same time," but there is no specific discussion of when the shares were issued, and this transaction apparently crosses a reporting date. Perhaps the example could be drafted to be intraperiod, or provide additional facts to more clearly establish the instruments were issued as part of the same arrangement and that the accounting being discussed is presumably for periods after 12/31/X1. Also, the fact pattern does not explicitly state as an assumption either that a) the shares and written put were contractually linked, thus failing to meet the criteria in paragraph 43(a) or b) they were issued to the same or a related counterparty, thus failing to meet a portion of the criteria in paragraph 43(b). Thus, in the example, it has not been clearly established why they were part of the same arrangement under paragraph 43.

### **Measurement**

*8. Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?*

While the fair value of a cash-settled instrument and a share-settled instrument with similar terms (except settlement mechanism) would be the same, there are fundamental differences in the settlement mechanism and the immediate effects on the financial resources of the company. If both of these instruments were

considered liabilities under the Basic Ownership Approach (as opposed to potential differentiation as equity or liabilities depending on settlement terms under the Ownership-Settlement Approach), we believe financial statement users would want additional insight into how the two types of instruments could settle. The conclusions as to financial statement presentation would be critical in clearly communicating this information to users.

At a more basic level, this question goes to the effects of volatility that would be reported in earnings and whether volatility based on the issuer's own share price is something that investors want the financial statements to reflect, or whether they would consider it "noise" to be factored out of their analyses. Measurement distinctions could be made between instruments that required settlement in cash and those that would or could settle in shares, even if both types were classified as liabilities under the Basic Ownership Approach. But, that would simply push some of the complexity from classification to determination of settlement consideration. Under US GAAP, preparers and auditors have already suffered through similar issues in the application of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," for several years. We would prefer any concerns with additional volatility in the income statement be addressed in the financial statement presentation rather than the measurement attributes for derivative securities.

Finally, as noted above, the complexity and other issues the FASB is currently struggling within the context of proposed FSP FAS 157-c would be confronted much more frequently in practice since the Basic Ownership Approach would require more of these instruments to be subsequently measured at fair value.

As to the specific guidance in the proposed Basic Ownership Approach, the concept in paragraph 16(b) that "instruments for which there are no existing measurement requirements would be measured using the existing framework" is not entirely clear. It seems somewhat circular -- if there are no current requirements for measuring a certain item, then how can there be an existing framework for measuring that item?

Also, within the PV, we were not clear as to how convertible debt would be subsequently measured. Instrument 18 in Table 2 of Appendix C indicates it would be accounted for at fair value with changes in value reported in income. However, paragraph 74 states that "instruments with embedded derivatives that cause their cash flows to vary more than just for changes in market interest rates would either be separated into a derivative and a host contract or be reported at fair value in accordance with the option in FAS 155." These two conclusions currently seem to be contradictory.

### **Presentation Issues**

*9. Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership*

*instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

We believe that further sub-categories within liabilities would better bridge the proprietary-based financial statements to the needs of other users (e.g., creditors, suppliers, customers) under the Basic Ownership Approach. In the US Firm's 14 February 1991 response to the DM, we stated the following:

*"We recommend that if the current balance sheet is to be modified, modification should be limited to including two components of both equity and liabilities. We believe that the segregation of liabilities and equity into sub-components would serve as an indicator to the financial statement user of the complexities or uncertainties associated with these instruments. The liabilities section of the balance sheet would include two categories: Liabilities and Compound Liabilities (or "Liabilities Potentially Convertible to Equity"). ... Equity would be segregated into two similar categories: "Compound Equity" (or "Equity that may be Redeemed") and "Residual Equity."*

While sounding naïve in today's environment given the proliferation of instruments and various accounting models (including bifurcation concepts), the basis for that comment is still sound in that there are various instruments with various economics and settlement alternatives that users may find meaningful in distinguishing within a particular category, especially one as potentially broad as "liabilities." A number of basic subcategories of liabilities would appear to be appropriate and worth consideration. These categories could be determined based on settlement attributes (e.g., cash, shares, a mixture of cash and shares, holder or issuer choice) or measurement attributes (e.g., amortized cost, fair value, redemption value) or a matrix of both attributes.

*10. Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.*

This question is broader than just accounting for liabilities and equity by the issuer, with holders facing similar challenges in accounting for investments that are carried at fair value. Issuers with instruments classified as liabilities would struggle with a transparent and meaningful presentation of both realized distributions on those instruments (interest or dividends) and unrealized changes in the carrying value of

those instruments (the gains and losses for those instruments accounted for at fair value). Taking that distinction between realized and unrealized transactions/measurements one step further, one could question whether interest paid in cash should be reported separately from the non-cash amortization or accretion of discounts or premiums. The similar challenge to holders is how to best present realized and unrealized investment returns for debt and equity investments that may be measured at fair value. These are examples where conclusions in the Conceptual Framework and Financial Statement Presentation projects intersect with this project, at least for the issuer. We would support a meaningful separation of liability and equity “costs” (dividends and interest) and changes between realized and unrealized amounts in the statement of financial performance.

As drafted, the guidance in paragraph 40 on reclassifications raises an additional question or point for clarification. Paragraph 40 seems to read as if a reclassification would never affect net income, regardless of whether the instrument is reclassified from a liability to equity or equity to a liability. The guidance could be read to require that the instrument be reclassified at its then-current carrying amount and then measured under its new measurement basis with that change reflected in equity. This would appear to contradict the current model wherein if an instrument is being reclassified to equity from liabilities, it receives a final “mark” through earnings as a liability and is then reclassified. We believe any final guidance should clearly state the intent of the model.

### ***Earnings per Share (EPS)***

*11. The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

Each of the three proposed models would share some baseline EPS issues. For example, under the current EPS model (or the current model as potentially to be amended), which numerator and/or denominator adjustments would need to be considered for the various instruments based on the classification and measurement attribute (i.e., what about convertible debt, if the conclusion was to measure it at fair value)? As another example, how would the two-class method need to be adjusted for participating instruments that were not a residual equity instrument and thus reflected as a liability (i.e., a second class of stock as noted in paragraph 19, or a forward that participated in dividends through a contract price adjustment)?

Other potentially relevant comments have been provided in the US Firm’s comment letters on the proposed Statement 128 amendment and will be provided on any future due process documents in that project. However, and more broadly, given the complexities (and some would say fundamental flaws) of the EPS model and the current accounting for liabilities and equity, even without regard for any potential

outcomes of the Liabilities/Equity project, we would recommend starting with a clean sheet of paper for any EPS model related to this project.

Specifically with respect to the Basic Ownership Approach, depending on the measurement basis for the related liabilities (including any obligations to contingently issue shares), there could be an opportunity to simplify the EPS model. For example, if all liabilities were reflected at fair value, then perhaps a single EPS number would be presented in which the dilutive effects of all potential common shares were already recognized in the numerator through the change in fair value included in net income. In that case, net income of the controlling interest would be divided by the average number of controlling interest residual equity securities outstanding to arrive at a single EPS amount. That would presume a fair value model for convertible instruments as well, which would merit further consideration as to whether the change in fair value reflected in net income was an appropriate measure of dilution for EPS purposes. One would also need to evaluate if such an EPS model was an appropriate measure of dilution for an instrument that was both marked to fair value and participated in dividends with common stock. Finally, EITF Topic D-98, "Classification and Measurement of Redeemable Securities," offers a potential model for redeemable instruments, focusing on whether the redemption is for fair value or not.

#### **QUESTIONS ON THE OWNERSHIP-SETTLEMENT APPROACH**

*1. Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.*

The Ownership-Settlement Approach could be viewed as an attempt to rationalize, to some degree, the current US GAAP model in the form of a "concept." Of the three models presented in the PV, we find this to be the least "conceptual" of the alternatives.

*2. Are there ways to simplify the approach? Please explain.*

Relative to the current US GAAP model, one could argue this approach is simplified given all the various elements of the literature that would be eliminated and replaced by a single standard. Literature related to indexation, classification, beneficial conversion features, variations on convertible debt instruments, modification versus extinguishment, conversion, induced conversion, extinguishments, and early extinguishments, among other guidance, would be centrally located in a single standard, dramatically improving the possibility that a preparer could at least identify the appropriate literature for consideration.

However, much of the complexity in the model is created by the need to identify the number and nature of possible outcomes, and then evaluate those outcomes for

potential separate accounting. A model built around those concepts would, in our view, be inherently complex relative to the Basic Ownership Approach.

### **Substance**

*3. Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?*

We believe issues around economic compulsion, similar to those identified in question 6 under the Basic Ownership Approach, would be present in the Ownership-Settlement Approach and likely to a larger degree.

To its credit, the FASB is using “substance” in part to incorporate the concepts of EITF Issue 00-19 in the context of the Ownership-Settlement Approach. That is, the model looks to probability when assessing the substantive nature of any term possibly forcing the entity to settle a share-settled instrument in cash, presumably addressing practice issues that today must consider highly remote but theoretically possible scenarios in classifying an instrument. If the Ownership-Settlement Approach is ultimately selected, we do agree that the probability of settlement in shares (rather than the theoretical possibility of having to settle in cash) is a critical element to meaningful presentation of equity-related derivatives.

### **Presentation Issues**

*4. Statement of financial position. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity’s potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

Our general comments under the questions 9 and 10 in the Basic Ownership Approach section are relevant for the Ownership-Settlement Approach as well. Conclusions on presentation within the statement of financial position and the statement of financial performance would be critical in communicating meaningful information under this model.

## **Separation**

*5. Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?*

As discussed above, much of the complexity in the model is created by the need to identify the number and nature of possible outcomes, and then evaluate those outcomes for potential separate accounting. Additional examples and illustrations of the application of the model to common instruments would be helpful in more fully considering this method.

One concern with the Ownership-Settlement Approach is that it does not explicitly state how mandatory dividends on perpetual instruments should be treated. Presumably the treatment should be the same as discussed for those dividends under the Basic Ownership Approach, otherwise there would be the potential for structuring equity instruments that were in substance more debt-like. (See also question B5 in Attachment B.)

Another concern with classification, which would affect separation, is the language in paragraphs A4, A8, and A21 that could be read to infer that such indirect ownership interests, whether freestanding or embedded, must share a return with holders of the underlying basic ownership interest on a one-for-one ratio. (See also question B5 in Attachment B.)

Convertible bonds that are denominated in a foreign currency do not appear to meet the requirements of the indirect ownership instrument and as such would be deemed to contain an embedded derivative rather than an equity component. Within a model based on fair value measurements, we generally disagree that the issuer's functional currency is relevant for the analysis of dual indexation of an embedded feature, as the US firm discussed more fully in its 24 May 2007 comment letter to the FASB's Proposed Statement 133 Implementation Issue C21, *Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Rates*, and its 5 May 2008 comment letter on draft abstract EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock." (See also question B5 in Attachment B.)

## **Earnings per Share**

*6. The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

Our general comments under question 11 in the Basic Ownership Approach section are generally applicable here as well. However, specific to the Ownership-Settlement Approach, this is relatively close to the current state of liability/equity

accounting, and thus the accounting underlying the current EPS model. As such, there may not need to be a fundamental modification to the current EPS model for there to be a workable model. However, that being said, we continue to believe there are fundamental flaws in the current EPS model which merit a complete revisit, even if an approach similar to the existing liability/equity model is retained.

#### ***Settlement, Conversion, Expiration, or Modification***

*7. Are the requirements described in paragraphs A35-A38 operational? Do they provide meaningful results for users of financial statements?*

We find the guidance in paragraphs A35-A38 to be almost incomprehensible as currently drafted without an illustrative example. The original summary materials released by the FASB on the Ownership-Settlement Approach in April 2006 appeared to more clearly describe the approach, perhaps due to the inclusion of illustrative examples.

#### ***QUESTIONS ON THE REO APPROACH***

*1. Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.*

In some ways we find this method superior to the others because it is based on a fundamental principle that has conceptual merit, which is attractive for reasons other than simplicity. However, the perceived difficulty in applying the REO approach for entities of various sizes and levels of sophistication makes it the least attractive alternative to us. However, we primarily base this view on our prior familiarity with the model as the PV only provides a limited description of the approach that, in our view, does not sufficiently explain the approach to others who are not already familiar with it. Also, the version of the REO approach proposed differs fundamentally from that initially explored by the FASB, which essentially reallocated the accreted value of the instrument rather than the current fair value.

#### ***Separation and Measurement***

*2. Do the separation and measurement requirements provide meaningful results for the users of financial statements?*

We believe the conceptual underpinnings for the separation and measurement of the components of compound instruments are sound. However, as discussed above, we are troubled by the complexity of its application.

### **Earnings per Share**

*3. The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

As this is a fundamentally different model from current practice, EPS would require a complete revisit. We understand that the Board has discussed, at least at a high level, the merits of an EPS model where the dilutive effect of potential common shares would be based on the expectation of the number of shares presumed to be issued as a result of the REO accounting allocations (i.e., the probability weighted number of shares to be issued). We would encourage this Board to more fully consider and expose this EPS model should the REO approach be considered a viable method.

### **OTHER ALTERNATIVES**

*1. Some other approaches the Board has considered but rejected are described in Appendix E. 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?*

We believe this is the opportunity for the standard setters to comprehensively revisit the liabilities and equity model. As the PV moves directly to considering three specific models without a comprehensive evaluation of the concepts, we are concerned the “best answer” given resources and cost-benefit to both preparers and users may be overlooked. For example, the January 2008 publication released by EFRAG and other national standard setters under the PAAinE initiative states in paragraphs 7.2 and 7.3 a view that a “claims only” approach is conceptually superior.

Among the methods rejected (or currently not being pursued) by the FASB are the claims approach and the loss absorption approach. We believe that a claims approach could be valid, and given appropriate measurement and disclosure, would allow various users of the financial statements to draw the appropriate “line” between equity and liabilities for their use. We believe that if standard setters must draw the “line” between liabilities and equity on the balance sheet, the loss absorption approach (as more fully described in the PAAinE initiative paper) has some appealing qualities that should be more fully explored. After drawing that line (perhaps using the loss absorption approach), then the consideration of sub-categories within liabilities could be explored. Therefore, after considering more broadly (and hopefully resolving) the conceptual questions regarding liability and

equity classification, we believe the Board should re-examine both the claims and loss absorption approaches if those are appropriate in light of the conceptual framework.

As discussed in our general comment letter, if the focus is on short-term convergence in either a joint project or a FASB-only project, we would also recommend considering the IAS 32 approach for the reasons cited previously.

**ATTACHMENT B  
RESPONSES TO SPECIFIC QUESTIONS IN IASB DISCUSSION PAPER**

*B1 Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?*

- A) Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?*
- B) Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?*

We do not believe that the three approaches set out in the FASB's PV are a suitable starting point for a project to improve and simplify IAS 32. There are numerous issues associated with IAS 32, some of which the IASB itself acknowledges in the criticisms described in the DP. However, given the scope of the PV and DP, we will not address those broader problems at this time. Please refer to our general comment letter for details of our concerns with the IASB implementing the FASB project.

*B2 Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?*

The scope of the project is restricted to basic ownership interests, other instruments that are ownership interests in legal form, and other contracts that are settled with basic ownership instruments or whose fair value is determined by prices of basic ownership instruments. We believe it is inappropriate to refer to the legal form of ownership interest in a standard with global application because of the considerable differences in legal terminology and requirements in different jurisdictions. If the characteristics of legal-form ownership instruments in the US are not already reflected in the criteria applied in the PV, then they should be; in which case the reference to legal form can be deleted.

*B3 Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any other jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?*

We believe there are situations where the Basic Ownership Approach may not provide an appropriate answer. One situation relates to jurisdictions where the law requires an entity to pay a minimum proportion of profits as a dividend, unless the shareholders vote at an annual general meeting (AGM) to waive the requirement. Under the Basic Ownership Approach, the fair value of the minimum dividend entitlement would normally be treated as a liability. However, the Basic Ownership Approach is based on an owner's perspective and so should reflect the owner's

rights and obligations. It follows that the shareholders acting together at an AGM should be considered an integral part of the entity and, therefore, the dividend entitlement should be classified as equity. Also, a requirement to pay out a proportion of profits is, arguably, similar to a partial put feature in the equity instrument, and so, by analogy with the treatment of puttable interests, should not prevent classification as equity.

The criteria for a puttable basic ownership interest to be classified as equity are more restrictive than the equivalent criteria in the recent amendment to IAS 32, which would prevent many puttable financial instruments from being classified as equity. IAS 32 now permits certain financial instruments to be treated as equity if they are puttable at the net book value as reflected in the IFRS accounts, even if this is not materially the same as fair value.

*B4 Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance.) If so, to which types of entities or in which jurisdictions are they inappropriate and why?*

We believe the principles of separation and linkage are broadly appropriate in distinguishing whether an instrument is equity or a liability. However, we have some questions about application and implementation which are considered in our response to the FASB in questions 5 and 7 under Questions on the Basic Ownership approach in Attachment A.

It is not clear as to the relevance of the principle of substance either to the Basic Ownership Approach, given its inherent simplicity, or to the Ownership-Settlement approach, given that it is significantly a rules-based model. It is also unclear as to the extent to which it encompasses economic compulsion as noted in our response to the FASB in question 6 under Questions on the Basic Ownership Approach in Attachment A. This is already a recognized problem with IAS 32. For example, a bond redeemable at the option of the issuer, that pays a dividend that increases after a certain number of years, but where the dividend is only payable if the entity pays a dividend on its ordinary shares, is considered under IAS 32 to be equity. This conclusion is regarded by many as counter-intuitive, since in substance the instrument behaves and is traded as debt. It is unclear from the PV how such instruments would be treated under the ownership-settlement approach.

*B5 Please provide comments on any other matters raised by the discussion paper.*

Please refer to our general comment letter for detailed discussion of the issues we have regarding the PV. We also highlight below a number of concerns we have with the Ownership-Settlement Approach and current guidance in IAS 32:

- The Ownership-Settlement Approach requires the value of an indirect ownership instrument to vary with changes in the value of the basic ownership instrument. Paragraph A4 states that the fair value should “be based on and vary in the

same direction” as the basic ownership instrument. This implies that there is no equivalent to the ‘fixed-for-fixed’ requirement in IAS 32. However, paragraph A21 of the PV also requires that the return on the indirect ownership instrument must be “in the same proportion” as that on the basic ownership instrument and an example given in paragraph A8 suggests that there needs to be a one-to-one ratio in the change of the two fair values. Consequently, it is not clear how the approach is to be applied. If a one-to-one ratio is required, then this would raise issues similar to those entities currently face under IAS 32 when applying the ‘fixed-for-fixed’ requirement.

Many convertible bonds have conversion ratios which are not fixed but vary over the life of the bond and most have a change in the conversion ratio on a change of control. The relaxation of the ‘fixed-for-fixed’ requirement would enable these instruments to be regarded as containing an equity component under the Ownership-Settlement Approach.

- Convertible bonds that are denominated in a foreign currency do not appear to meet the requirements of the indirect ownership instrument and as such would be deemed to contain an embedded derivative rather than an equity component. First, the fair value of the conversion option does not necessarily change in the same direction as the underlying share if there are changes in exchange rates. Second, contrary to paragraph A4(c)(2) of the PV, the conversion option would contain a ‘contingent exercise provision’ based on a price index that is unrelated to the price of the entity’s basic ownership instrument or its own operations (i.e., the price index varies with foreign exchange rates). (See also question 5 under Questions on the Ownership Settlement Approach in Attachment A.)

As with IAS 32, it is unclear from the PV how foreign currency denominated convertible bonds are treated in consolidated accounts. For instance, a convertible bond issued by a subsidiary but denominated in the functional currency of the parent rather than the subsidiary, would presumably not be equity at the level of the subsidiary. However, applying the concepts of the Ownership-Settlement Approach it ought to contain an equity component at the consolidated level. However, since there is a rule explicitly set out under the Basic Ownership Approach, and presumably also applicable under the Ownership-Settlement Approach, that the debt or equity classification in a subsidiary is maintained on consolidation, it is not clear whether this is the right conclusion. Likewise, a subsidiary could issue convertible bonds denominated in its own functional currency which arguably would not contain an equity component at the consolidated level if the bonds are convertible into the shares of the parent which has a different functional currency. Should the equity component be reclassified as an embedded derivative on consolidation?

- The Basic Ownership Approach indicates that mandatory dividends on a perpetual instrument should be treated as a liability; however there is no specific guidance on how the Ownership-Settlement approach would treat such dividends. We presume that the same principle would be applied under the Ownership-Settlement Approach. To do otherwise would give huge potential for structuring by allowing equity presentation for instruments that would be, in

substance, debt. If the IASB decides to consider the Ownerships-Settlement Approach in more detail, the wording should be amended to address this point.

- The treatment of convertible bonds that may be converted during the life of the instrument is not clear under IAS 32. The rules in IAS 32 and examples provided only deal with instruments that convert at maturity. The Ownership-Settlement Approach is not clear on this issue either. Instruments that can convert over the life of the instrument give rise to significant problems in determining what to bifurcate, the portion of the instrument that should be considered equity, and the accounting treatment on conversion. These issues will need to be addressed if the IASB chooses to adopt the Ownership-Settlement Approach. (See question 7 under the Questions on the Ownership-Settlement Approach in Attachment A.)