

October 30, 2003

Mr. Robert Herz Chairman, Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, Connecticut 06856-5116

Dear Chairman Herz:

The Committee on Private Companies ("CPC") of Financial Executives International ("FEI") wishes to thank you for making Halsey Bullen available to us in St. Louis earlier this month to explain the Financial Accounting Standard Board's (FASB) recently promulgated Statement of Financial Accounting Standards No. 150 ("SFAS 150"). FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives, nearly half of which are from non-public, for profit companies. CPC is a technical committee of FEI, which reviews and responds to existing or proposed legislation or regulations that affect non-public companies. More than 250 private companies are represented in CPC. This document represents the views of CPC and not necessarily the views of all FEI members.

During our meeting with Mr. Bullen we appreciated the openness of the discussion, and his willingness to hear concerns regarding the new standard. We also thank the FASB for its delay of one year of implementation for non-public companies and the opportunity to comment on SFAS 150 through issuance FASB FSP 150-c.

The CPC understands the FASB's concept that one set of accounting standards should be used uniformly for both public and private companies. We appreciate the opportunity to work closely with FASB in crafting a document that addresses the concerns of all parties.

The purposes of this letter are to:

- 1. Note several unintended consequences that will result from the application of SFAS 150.
- 2. Address the characteristics common to non-public companies that may form the basis for distinctions in accounting treatment, and
- 3. Propose a change that eliminates or reduces the unintended consequences of SFAS 150 application.

The statement, as currently written, has inadvertently invoked the **law of unintended consequences**. We are aware that the FASB has already received feedback regarding what many believe will be the negative impacts of SFAS 150 on the ability of private companies to compete for capital and business opportunities. We have outlined several cases to illustrate our concerns in the attached Appendix A. It seems that a purpose of financial reporting – to communicate the financial condition and results of operations of an enterprise – will be frustrated for private companies rather than enhanced due to these **unintended consequences**.

The potential impact of SFAS 150 on current financial reporting in private companies has significantly raised the awareness of the owners of privately held companies about FASB and its standard-setting processes. While earlier comment periods provided an opportunity for private companies to have input into the standard setting process, it is only since publication of SFAS 150 that many non-public companies have understood the implications. We welcome FASB's current outreach efforts to the non-public company community so that the full extent of the standard's impact can be better understood and debated.

The vast majority of companies in the U.S. are privately held. SFAS 150, as currently written, has a substantial negative impact on private companies which is causing a great deal of concern to the preparers and users of private company financial reports. Although CPC believes strongly that the FASB's standard setting process should remain in the private sector, other organizations may find the impact of the current SFAS 150 on privately held companies' sufficient cause to politicize this issue and create yet another unintended consequence. CPC remains committed to working diligently within the FASB due process, but with the expectation that improvements will continue to be made to SFAS 150.

The current responses from our member firms to SFAS 150 present a significant challenge to the concept that both private and public companies should use one uniform standard for all financial reporting. While we recognize the Board's desire for one standard to apply to both public and non-public companies, there are several important characteristics that are unique to non-public companies. We believe that within these characteristics lie important distinctions that can be utilized to eliminate or reduce the **unintended consequences** of SFAS 150 while maintaining the single-standard approach. Among these distinctions are:

- Private companies often have all or a substantial portion of their equity subject to mandatory redemption.
- Private companies have stock that is closely held, typically by employees, directors, officers, family members and other affiliated entities.
- 3. The nature of equity in a private company has long been recognized to be different than equity of a public company because there is a direct relationship between share ownership and equity that is not present in public companies.
- The interests of shareholders/owners and management are truly aligned in a non-public company. "Harvesting of value" normally occurs over time, sometimes over generations,

and under very specific contractual terms and conditions of a buy/sell agreement designed to protect the integrity of the entity and safeguard the owners.

Furthermore, CPC has identified several questions and problems regarding the application of SFAS 150 to non-public companies which we have detailed below.

- SFAS 150 may communicate apparent insolvency to the financial community and shareholders in a manner which is misunderstood
- In many jurisdictions, a professional corporation's equity is required to be mandatorily redeemable.
- Commercial laws allow privately held companies to pay dividends and redeem shares if
 the fair market value of the assets exceeds liabilities. If SFAS 150 is implemented for
 private companies, the reclassification of equity as a mandatory redeemable obligation
 could appear to prevent or restrict the payment of dividends or the redemption of shares
 without the application of non-GAAP commercial law.
- Many privately held companies pay dividends. For example, many privately held companies are Subchapter S corporations. As such, they do not pay taxes, but rely upon dividends to shareholders in an amount sufficient to allow the shareholders who receive the pass-through income to pay the appropriate taxes. Impeding the ability of a Subchapter S corporation to pay dividends as a result of the reclassification between equity and debt required by SFAS 150 is extremely penalizing and would be another unintended consequence. We believe it would be best for financial statements to prima facia show why dividends can be paid.
- Because privately held companies often have mandatorily redeemable shares and their fair market value normally exceeds equity, SFAS 150 requires the recording of a liability in excess of book value. However, while the excess of the liability over book value is often a reflection of the increased value of the business, SFAS 150 does not provide for the recognition of this appreciation. It is interesting that SFAS 150 would require reflecting the liability at fair market value, but not address adjustments to the book value of assets to reflect the increased value of the business upon which the liability is based.
- Similarly, contingent assets (i.e. mortality benefit of life insurance) commonly present to fund redemptions are also not considered under SFAS 150.
- The fair market value of any company, public or private, is frequently based on projected future earnings. Flowing the change in fair market value though the income statement is not consistent with the principle of matching current revenues with expenses. Rather the change in fair market value represents a change in valuation driven by the economic outlook of the business. This change may be driven by many factors outside the control of the business including market demand and the strength of the economy. It would be inappropriate to recognize these changes in current operating performance through a charge to earnings.

- SFAS 150 effectively redefines "public" companies as SEC registrants, even if the entity meets the definition of a nonpublic entity in SFAS 150. There are a number of nonpublicly traded entities which are SEC registrants solely due to the number of their shareholders with most, if not all, of those shares being subject to mandatory redemption agreements. In another example of unintended consequences, those companies will be in a unique position of being the only entities reporting to the SEC with no equity, since public companies generally do not have all equity as redeemable stock. Their financial statements would not be comparable to their publicly traded counterparts. Further, this unique position may well endure beyond the extension of the effective date of compliance for non-public companies, as non-compliance is not an option for SEC registrants. This effectively creates accounting differences between public and non-public SEC registrants.
- We are concerned how the U.S. Comptroller of the Currency and bank regulators might respond in its review of a lender's portfolio that includes numerous apparently insolvent borrowers. It is possible that a good credit today may be reclassified as a bad credit by the examiner immediately after SFAS 150. Congress has been specific over the years that Regulatory Accepted Accounting Principles must follow Generally Accepted Accounting Principles. Regulatory agencies interacting with banks that are impacted by SFAS 150 include the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervisors (OTS). Representatives from the agencies have acknowledged that they will have to develop alternatives to GAAP calculations if SFAS 150 in its current form is implemented, yet being responsive to Congressional direction will be difficult.
- ESOPs own a substantial amount of private company equity. These ESOPs were created
 by Congress to encourage employee ownership, have third-party trustees, and
 independent appraisers value its shares. Our concern is, that if the ESOP owns less than
 100% of the entity, or a small enough portion of equity, the non-ESOP mandatorily
 redeemable shares could cause the entity to be insolvent after implementation of SFAS
 150. This may result in expanded concerns under fiduciary laws governing independent
 trustees and appraisers.

As a result of these unintended consequences referenced above, some of our members have suggested that they may do some of the following to avoid compliance with SFAS 150:

- Some private companies will simply not adopt the new standard. They will accept a
 qualified or adverse audit opinion. Their lenders and investment bankers have already
 agreed to this position, and will accept the qualified or adverse audit opinion.
- Other private companies have indicated they will "sharp shoot" SFAS 150 by "tweaking" the wording in existing mandatory redemption agreements to ensure compliance with the "letter of the law", but not with the concept.

3. A few private companies have indicated SFAS 150 as written may climinate their ability to pay dividends, as their particular state laws/regulations prohibit companies with negative equity from declaring a dividend. These firms have indicated they would take their case to their state legislators for redress and correction.

To prevent the unintended consequences listed above, the CPC strongly urges the FASB to modify SFAS in the following universal manner:

➤ For companies where a "substantial portion" of the shares outstanding are subject to mandatory redemption, or where the shares are held in a qualified retirement plan, those shares be excluded from the scope of SFAS 150.

Rather than separate public from private accounting, this methodology utilizes valid distinctions between public and non-public companies. The result would be to preclude most, if not all, public companies from utilizing the specific exclusion, while allowing most private companies to utilize the specific exclusion.

Finally, the CPC suggests that footnote disclosure be mandated in any case that utilizes the exclusion listed above, noting the general terms of the redemption agreement, and any external funding sources that are maintained to fund any redemption event, if any. Captioning equity as "subject to redemption under certain agreements" could also be mandated.

Once again, CPC appreciates the opportunity to provide the Board with comments on SFAS 150, and we would like to make ourselves available for a dialogue with the Board. If you have any questions or wish to discuss this letter further, please contact FEI staff member Bob Shepler at 202 626-7806 or bshepler@fci.org.

Sincerely,

Robert A. Orben

Chair, Committee on Private Companies

A Milia

Financial Executives International

CC: Suzanne Bielstein, Director, Financial Accounting Standards Board Halsey Bullen, Financial Accounting Standards Board Staff Gerald Laporte, Chief, Office of Small Business Policy, US SEC Grace Hinchman, SVP of Public Affairs and Technical Activities, FEI Christine DiFabio, Director of Technical Activities, FEI Committee on Private Companies

Appendix A

Illustration A

Negative Equity

A highly profitably company with little debt, and low book value, is 100% employee owned. Its fair market value is many times the book value of the company. Under the terms of the shareholder buy-sell agreements, upon the death or termination of a shareholder/employee, the company is required to repurchase the ownership interest at its appraised fair market value.

Result: SFAS 150 requires the fair market value of all shares to be reflected as a liability resulting in negative book equity with a significant increase in recorded liabilities. The company may appear to be insolvent. This is because the liability is shown at the fair market value, but the assets are not correspondingly reported at fair market value. The negative equity balance is a reflection of assets not recorded on the Balance Sheet.

Illustration B

Negative Events Result in Increased Current Year Earnings

A 100% family owned, profitable company has its shares subject to buy-sell agreements that require the company to redeem the shares on the death or termination of the shareholder. Its revenues are derived largely from multi-year contracts with a limited number of customers. At the end of Year 1, based largely on the customer contracts and high profitability, the company is valued at \$100 million, which is the recorded liability amount under SFAS 150. During Year 2, the company experiences operating problems and prior to year-end several large customers cancel their contracts due to non-performance. The company reports \$0 net income for the year. Based on these new facts, the value of the company has decreased to \$50 million.

Result: The recorded liability at the end of Year 2 is reduced from \$100 million to \$50 million. The change is presumably run through the income statement resulting in a net increase in earnings of \$50 million that is derived from a substantial decline in value of the company.

Illustration C

Unsolvable Monetary Value Scenario

A company has a market value that is equal to its pre-SFAS 150 book value. 100% of its shares are subject to mandatory redemption. The stated redemption price is book value.

Result: The recorded liability under SFAS 150 reduces the book value of the company to zero, which reduces the monetary value under the redemption requirement to zero, which then raises the book value back to its pre-SFAS 150 amount, which then becomes the redemption price..... Results in an unsolvable circular equation.