

**AICPA**  
**PCPS Technical Issues Committee (TIC)**  
Steve McEachern, Chairman

September 29, 2003

Mr. Lawrence Smith, CPA  
Director, TA&I-FSP  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position (FSP) 150-b, *Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount that Differs from the Book Value of Those Shares, under FASB Statement No. 150*, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity"

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the above-referenced proposed FSP and is providing the following comments for your consideration.

TIC continues to disagree with recording these types of agreements as liabilities for privately held companies and believes the presentation in Proposed FSP FAS 150-b highlights the problems with this approach, especially where redemption amounts are based on fair value. In these cases, the better the company performs, the worse the income statement will look. For a growth company whose value is increasing each year, the amount of "interest expense" will be significantly in excess of any original expense recorded. TIC does not understand the justification for considering this increase in the shareholder's value as a cost of capital.

**Arguments against the interest expense presentation.** TIC thereby rejects the interest expense presentation. Rather, one could argue that equal justification exists for an asset model. If the value of an entity's shares is to be classified as a liability based on a re-evaluation of the recognition model for financial instruments with characteristics of both liabilities and equity, then perhaps equal weight should be given to classifying the debit representing the excess of fair value over cost basis as an asset (goodwill) at transition. The same criteria that gave rise to recognition of the liability also support recognition of the fair value of the company over its

recorded equity. The reduction of equity to a negative balance by recording an expense would not be consistent with, nor representative of, the transaction and would be counterintuitive.

In subsequent periods, at least part of the necessary adjustment to the liability would be debited (or credited, as appropriate) to goodwill in recognition of the increase (decrease) in the company's value. If the ultimate amount to be paid and the settlement date are fixed, part of the adjustment would be interest expense. If the settlement terms vary, the entire adjustment would be to goodwill. In summary, it appears that an event has occurred that should give recognition to both aspects of the transaction, even though the recognition of goodwill would not otherwise be allowed by SFAS 142, *Goodwill and Other Intangible Assets*.

The interest expense presentation also runs counter to another asset issue that is ignored in SFAS 150 and EITF 88-5, *Recognition of Insurance Death Benefits*. The EITF consensus states, "The death benefit may not be realized prior to the actual death of the insured, and recognizing death benefits on a projected basis is not an appropriate measure of the asset." Clients that own life insurance policies on their shareholders don't understand why they must recognize the full liability for mandatorily redeemable shares without also recognizing a related asset for the proceeds to be received (not just the cash surrender value). They claim financial statements for these insured companies will not be representationally faithful since assets that would be available to satisfy the obligation are not included on the balance sheet. This argument has new meaning given the measurement requirements in SFAS 150.

TIC believes the argument has merit. Many obligations are already recognized as liabilities and measured on an actuarially determined basis. SFAS 150 has established a measurement criterion that is one step beyond past accounting principles. Now the liability for mandatorily redeemable shares with variable payment or settlement terms must be recorded at the amount of cash that would be due at the reporting date. TIC believes it is inappropriate to require an entity to measure a future obligation at full value as of the current balance sheet date without reporting an asset for the insurance proceeds to which the entity would be entitled if the insured died as of the same date. The requested balance sheet presentation would give financial statement users a true picture of the adequacy of insurance coverage obtained by the entity for SFAS 150 buybacks, deferred compensation arrangements and other related obligations. TIC believes this presentation would provide practical information to financial statement users thereby enhancing the quality of financial reporting.

TIC also believes FASB Concepts Statement 6 (CON 6), *Elements of Financial Statements*, supports the case for asset recognition of goodwill or insurance proceeds. Paragraph 26 of CON 6 defines the three essential characteristics of an asset:

*(a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. Assets commonly have other features that help identify them—for example, assets may be acquired at a cost [footnote omitted] and they may be tangible, exchangeable, or legally enforceable. However, those features are not*

*essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the entity in producing or distributing other goods or services. Similarly, although the ability of an entity to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways.*

It appears the recording of an asset for the benefit of life insurance or goodwill is justified based on the definition espoused in CON 6, and as clarified by SFAS 150. Obviously, items (a) and (b) had already been met prior to the issuance of SFAS 150 in both these cases. The clarification provided by SFAS 150 indicates that the recording of a liability is based on entering into a contract that gives rise to the potential obligation that contains "an event certain" and defines that as the triggering event, rather than when the actual event giving rise to a current obligation takes place (i.e., death). In the case of life insurance, it would be logical that the same conditions exist and give rise to an asset, since the event of death has been deemed by FASB to be an event certain, and a contract has been entered into giving rise to the entity's right to or control of the benefit. While it may be true that an entity can change the terms of a life insurance contract, this is also the case with instruments containing elements of liabilities and equity, particularly in the case of nonpublic entities with related parties controlling such decisions. The same arguments can be applied to goodwill, as an event has now occurred that gives rise to the recording of an asset.

Given the SFAS 150 change in liability recognition and measurement and the existing guidance in CON 6, TIC questions the validity of the consensus reached in EITF 88-5 and suggests that it be reconsidered.

Another alternative that TIC would like to suggest is to classify the transition amount and the "annual adjustment" as other comprehensive income (OCI). The payout on many of these liabilities will not be triggered for many years to come. To have changes in fair value reflected in the income statement causes meaningless fluctuations in net income over time. An analogy may be made to the accounting for changes in the market values of available-for-sale securities, which are also a separate component of OCI.

The interest expense classification advocated in the Proposed FSP also seems counterintuitive if the entity suffers consecutive reductions in the fair value of its shares through the years such that fair value is less than book value. Would the company record negative interest expense (interest income) in this situation? This is not clear from the Proposed FSP.

TIC noticed that SFAS 150 itself seems ambivalent about use of the term "interest expense." Paragraph A6 requires that the issuer present interest cost and payments to the stockholders separately from interest and payments to other creditors in both the statement of income and statement of cash flows. Such differential treatment implies that interest on mandatorily redeemable securities is different from interest on trade debt – a sign to TIC that it should be given another name and perhaps a different classification.

**Transition issues.** TIC also disagrees with the transition guidance and believes restatement should be permitted for privately held entities. TIC believes it is inappropriate to record a cumulative effect adjustment in the income statement that will impact net income. If the FASB cannot be persuaded that the transition amount and the majority of subsequent adjustments are assets or components of other comprehensive income, TIC suggests that material adjustments be classified as restatements to minimize distortion of the current period income statement. TIC understands that public companies try to avoid restatement accounting so as not to be required to revise prior SEC filings. In contrast, most private companies would not have a reason to avoid restatement since it would not be necessary for either tax or regulatory purposes. Furthermore, users of private company financial statements are more concerned with net income and may misinterpret the impact of a cumulative effect adjustment.

**Clarity and scope issues.** TIC believes the proposed FSP is very confusing as written and is too limited as to scope. TIC recommends that the examples and text be revised to improve clarity and that the scope be expanded to include the accounting for new fair value buyback agreements, not just those existing as of the effective date of SFAS 150.

Our specific comments and recommendations follow regarding the clarity of the proposal.

*Scope Issue.* TIC was disappointed that the guidance provided is meant to apply to only those mandatorily redeemable fair value buyback agreements that are in existence at the transition date. The title of the proposal implies that its scope covers the accounting for both new and existing fair value buyback agreements. TIC believes the proposal's scope should be expanded to cover agreements that are initiated after the effective date of SFAS 150. SFAS 150 did not address fair value buyback agreements at all. Therefore, questions will arise regarding the accounting for new fair value buyback agreements initiated after the effective date of SFAS 150. Is the entire redemption amount recorded in the income statement or just the amount in excess of equity? What is the debit called? Is the balance sheet presentation the same?

If the FASB decides not to follow our recommendation, then we ask that the first paragraph of the FSP be rewritten to clarify that the accounting that follows is only transition and subsequent accounting guidance for those agreements in place as of the effective date.

*Presentation of Examples.* Example 1 should include a statement of changes in shareholders' equity to illustrate how a company should present the change in year one; otherwise, the prior year ending equity will not reconcile with the cumulative adjustment presented.

Example 2 should be consistent with example 1 and illustrate the income statement of all components, especially the excess of common stock and retained earnings attributable to the mandatorily redeemable shares over redemption amount. It is crucial that guidance be provided describing the income statement caption when the fair value of the mandatorily redeemable shares is less than book value.

Finally, TIC suggests that more explanatory text accompany the examples so that important calculations, relationships and disclosures may be more readily understood.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen M. McEachern, Chair  
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees