

LETTER OF COMMENT NO. 32

Mr. Russell G. Golden, Director of Technical Application and Implementation Activities Financial Accounting Standards Board 401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: Proposed FSP APB 14-a

Dear Mr. Golden:

The Stanley Works ("Stanley") appreciates the opportunity to respond to the proposed FASB Staff Position ("FSP") identified above. Stanley is a diversified worldwide supplier of security solutions for commercial applications as well as a manufacturer of tools and engineered solutions for professional, industrial, construction and do-it-yourself use with reported 2006 sales of \$4 billion. In March 2007, Stanley completed a \$330 million convertible note offering with terms identical to "Instrument C".

We respectfully submit our view that the guidance specifying the application of "debt plus detachable warrant" accounting to Instrument C in the proposed FSP APB 14-a is not appropriate. The issuance of this FSP would misstate corporate financial positions as the amount of debt reported on corporate balance sheets for Instrument C will be materially lower, typically 20-35%, than the true cash obligations. As a point of reference there have been approximately \$111 billion of Instrument C securities issued since the beginning of 2006 and we estimate this proposal would understate and move off balance sheet in excess of \$30 billion of cash liabilities for this short period alone. The magnitude of the understatement of cash liabilities for all issuances that remain outstanding is significantly more than the \$30 billion related to this small sampling period.

Hybrid financial instruments are complex and continually evolving, as evidenced by the Board's ongoing liabilities and equity project and EITF 07-5. As recently as early 2007, the Board wisely rejected proposals to undertake a short-term project focused solely on convertible bonds, in favor of a more appropriate and comprehensive approach in the broader liabilities and equity project. This earlier position of the Board recognized that further analysis is needed, along with sufficient due process with affected parties, to arrive at an accounting standard proscribing consistent treatment for similar securities. This FSP would result in lack of comparability and inconsistency in convertible bond reporting because similar, inseparable instruments would be accounted for very differently. The proposed guidance would diminish transparency in financial reporting. We believe an appropriate accounting treatment would be more effectively addressed in the comprehensive liabilities and equity project, which is expected to include guidance on accounting for all types of convertible bonds and other hybrid instruments. This

approach would result in more consistent application and avoid potential divergence in accounting theory.

The FSP process, with its inherent speed, is best reserved for technical clarifications of existing guidance, not a substantial overhaul of extensive existing GAAP which should instead be addressed by a FASB statement. The rapid effective date of the proposed FSP would exacerbate confusion in capital markets. The complexity of issues pertaining to the accounting for Instrument C is demonstrated by the inability of the Emerging Issues Task Force to reach a conclusion on this topic a few months ago, as well as the fact that this FSP would nullify two existing EITF's and amend another five, all of which were created to help interpret the conclusions reached in APB 14. Accounting for Instrument C clearly should be merged into the comprehensive liabilities and equity project to permit appropriate deliberation of the issues, and sufficient time to educate financial statement users prior to implementation. A comprehensive standard would increase transparency and improve efficiency in global capital markets.

Inseparability

The proposed FSP would incorrectly account for one instrument as though it were two separate instruments, in a manner theoretically inconsistent with the wider framework of current US GAAP. In the ratification of APB 14, the Board fully considered the alternate views as to whether convertible debt should be recorded solely as debt or rather that the conversion feature should receive separate accounting treatment at time of issuance, weighing the same theoretical issues contemplated by this FSP. In particular, as is observed in paragraph 7 of APB 14:

"The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and conversion option...The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa."

Instrument C is one hybrid instrument and not two separable instruments. The inseparability of the equity feature of Instrument C is a legal and substantive economic fact. The conversion option can not be separated and traded. Upon conversion, the holder forgoes the benefits of redemption, as the debt claim in bankruptcy and the right to future interest payments are surrendered. Inseparability was the primary basis for the conclusion in paragraph 12 of APB 14 that no portion of the proceeds from issuance of the types of securities described in paragraph 3 should be accounted for as attributable to the conversion feature. Instrument C has all the characteristics described in APB 14 paragraph 3:

"The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to anti-dilution provisions."

In paragraph B3 of the proposed FSP APB 14-a, the Board, in articulating its rationale to exclude Instrument C from the scope of APB 14, states:

"Opinion [14] contains no discussion of convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion"

Paragraph B3 of the proposed FSP further says:

"In contrast [to convertible debt that may be fully settled in shares], the issuer of a convertible debt instrument with the characteristics of Instrument C is required to repay the debt in cash and can elect to settle the conversion spread in either cash or shares."

Net share of settlement of Instrument C does not make its debt and equity elements separable in economic substance so this logic is not a compelling basis to account for Instrument C differently than other convertible debt. In APB 14 paragraph 18, the Board recognized it was not possible to list out all types or features of hybrid instruments as follows:

"not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction."

The Board explicitly observed that Opinion 14 could not address all forms of debt with conversion features, but it established a logical basis to assess the accounting for other forms of convertible debt. Current US GAAP for Instrument C is consistent with this framework, and reflects the substance of its inseparability. We do not agree with the view expressed in paragraph B5 that because Instrument C possesses both an equity component and debt component at time of issuance this justifies bifurcation:

"For purposes of this FSP, the Board decided to require that a convertible debt instrument that may be cash settled upon conversion be separated into its liability and equity components..."

Why would the accounting for straight convertible debt not be bifurcated at time of issuance as well since it equally feasible from market data to bifurcate the equity element from straight debt? Straight convertible debt has the ability in the future to potentially be converted to stock or to be repaid in cash (i.e., no conversion). Instrument C does not have different economic substance to the holder as compared with convertibles that may entail settlement entirely in shares.

The ability to separately sell and the existence of a market at the time of issuance is the basis for the bifurcation of debt with detachable stock warrants. However, since no market exists and the holder of Instrument C can not sell the conversion feature alone, bifurcation is inappropriate. To require bifurcation of Instrument C and yet leave accounting for straight convertible debt unchanged is inconsistent.

The proposed FSP may undermine SFAS 133. The FSP's separation methodology contradicts FAS 133's methodology for separating embedded derivatives which can not be legally separated from host contracts. The proposed FSP may set a precedent for analyzing other embedded derivatives, aside from convertibles, outside the guidance in FAS 133 leading to inconsistent application in separating equity derivatives. It seems US GAAP should have one "separation" framework method applied consistently for financial instruments, rather than one for FAS 133, a different one for debt plus warrant accounting and a third for recognizing beneficial conversion options.

The notion that the ability to transfer a component is a pre-requisite to apply bifurcation accounting is consistent with certain other U.S. GAAP. While not directly related, but relevant with respect to the theory of when to bifurcate, Emerging Issues Task Force 00-21 - Accounting for Revenue Arrangements with Multiple Deliverables ("EITF 00-21"), discusses when a revenue transaction should be accounted for under multiple elements. Specifically, one of the three criteria required for bifurcation of the revenue streams is that the delivered item should have stand alone value to the customer. EITF 00-21 defines stand alone value as meaning a market exists for the item such that it is separately resalable by the customer in an observable market for the deliverable. In the case of Instrument C, there is no stand alone value of the conversion feature for the reason specified above (i.e., no market and no ability of holder to sell).

Earnings Per Share

In paragraph B3, the Board states the purpose of this FSP is to eliminate inconsistencies that may exist in accounting for convertible debt and related share dilution calculations as follows:

"The Board believes that the inconsistency between the accounting for those instruments (as convertible debt) and the diluted earnings-per-share treatment (as debt issued with detachable warrants) has led to a proliferation of convertible debt with the characteristics of Instrument C in the marketplace. The Board believes that those inconsistencies can provide misleading information to investors"

Accounting for Instrument C under current GAAP is consistent with the theoretical framework established in APB 14. Under this approach, debt is fairly stated on the balance sheet, the income statement is not distorted with non-cash expense that is never actually cash settled, and earnings per share reflects the dilution that would occur in the applicable reporting period. It is true there is less dilution with Instrument C than with straight convertibles but that does not make the reporting misleading, as the dilution reflects the terms of the respective convertibles. It would not be appropriate to reflect dilution on Instrument C as though the entire offering were stock-settled; the dilution reported reflects the economic substance of net-share settlement of the conversion feature. The economics of the inseparable option embedded in the Instrument C convertible bond are fairly represented by the dilution reflected in the current accounting.

It appears more misleading to reduce earnings for non-cash interest expense that will never be paid in cash, particularly considering that the economic substance of Instrument C to the investor is the same as with straight convertible debt. Also, the proliferation of a particular security is not a compelling reason to change the applicable accounting when such a change is theoretically unsound.

Off Balance-Sheet Debt & Broader Economic / Investor Considerations

Instrument C represents a debt obligation for the par amount of the convertible bond. The obligation is known at the time of issuance and is not accreted to a future value based on the time value of money. This fact pattern makes recognition of the par amount as debt

on the balance sheet appropriate and in accordance with the FASB's definition of a liability as stated in CON 6:

"Probable future sacrifices of economic benefits arising from present obligations of an enterprise to transfer assets or provide services to others in the future as a result of past transactions or events."

In pursuing what appears on the surface to be more appropriate interest expense, the FSP would cause greater damage by increasing off-balance sheet debt. The proposed guidance would create permanent differences between reported earnings and cash flows by requiring recognition of non-cash interest expense. Investors are not clamoring for reporting changes that entail permanent disconnects between reported earnings and the cash flow statement, and are likely to be confused by what will be perceived as less transparency in both the balance sheet and earnings. In simple terms, the proposed FSP places a higher value on the recognition of non-cash expense in earnings than the fair representation of cash liabilities. Further, the annual magnitude of the earnings charge for this non-cash interest expense (that is in fact never paid), is a mere fraction of the balance sheet misstatement, a misstatement that will persist for many years.

Economic harm to creditors and investors in certain entities may ensue because restrictive covenants in non-convertible debt borrowings do not always provide for automatic revision based on potential future changes to US GAAP. Further leverage may occur, beyond the amount that creditors and lenders had priced into existing offerings or credit agreements, due to the apparent increase in borrowing capacity arising from the understatement of convertible debt created by the this FSP, thus potentially increasing other creditor risks. This misrepresentation of corporate cash liabilities is being proposed at time when there has been a marked decline in the credit quality of corporate America. The number of investment grade credits in the S&P 500 has decreased by 11 percentage points since 2002. This is merely a tip of the ice berg, but is indicative of the overleveraging that has occurred over the last five years that has precipitated the subprime crisis and the ensuing liquidity crunch that all investors are concerned about. So at a time when the most pressing issue facing the investors and creditors in the United States, and in fact the world, is the decline in credit quality and the deterioration of the balance sheet combined with the miss-pricing of risk, FASB is proposing a significant change in accounting that will dramatically understate cash liabilities. Clearly the interests of investors would not be served by this proposed FSP. The proposed change is inconsistent with the conservatism principle from a balance sheet perspective..

Response to Issues Regarding Which the Board Solicited Comments

With respect to the three issues the Board specifically solicited comments on, our views are as follows.

<u>Issue 1:</u> The proposed FSP requires that the liability and equity components be separated based on a residual method whereby the fair value of the liability without the conversion feature would be recorded and the residual value attributed to the equity component. This method is likely easier to apply consistently than recording the fair value of the

equity component and ascribing the residual value to debt. However we do not understand why a different basis of accounting would be established than the relative fair value approach proscribed for debt plus detachable warrants in APB 14 paragraph 16. While it may be easier in practice, such an approach creates further inconsistencies in the absence of completely superseding all provisions of APB 14.

Issue 2: References to other GAAP improve the understandability of the FSP. However, it is strongly preferred to have standalone comprehensive guidance, as would occur by addressing the accounting for all convertible debt in the FASB statement to be issued pertaining to the liabilities and equity project.

<u>Issue 3:</u> The illustrative example in Appendix A improves the understandability of the FSP and should not be deleted.

We recognize the Board's initiative in this FSP is intended to improve a complex accounting area. However, we believe the proposed FSP does not provide an improvement to current accounting literature because:

- It would engender inconsistency in financial reporting..
- It will cause a material increase in off-balance sheet debt, eroding reporting improvements that reduced off-balance sheet items following Enron.
- The matter should be addressed in the more comprehensive liabilities and equity project to ensure potential issues are adequately deliberated and researched. This would also permit an orderly transition and minimize confusion for financial statement users.
- The proposed FSP would materially understate (and move off-balance sheet) cash liabilities in order to record a non-cash expense in earnings.

The economic plague of this decade has been excessive leverage. This proposal would reduce transparency when it is needed the most and would harm investors by placing debt off-balance sheet, thereby exposing them to even more leverage than they priced for, at a time when credit risk was under-priced. The unintended consequences of this proposal may be to encourage more leverage at a time when we need it the least.

We appreciate the Board's consideration of our comments. Should you wish to discuss any of these views, please contact Don Allan at (860) 827-3858.

Sincerely,

Donald Allan

Vice President and Corporate Controller

Craig Douglas

Vice President and Treasurer