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Comment Letter on FASB Preliminary Views Financial Instruments with Characteristics of Equity Accounting & Auditing Committee-The Ohio Society of CPAs



LETTER OF COMMENT NO.

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May 23, 2008

Financial Accounting Standards Board Attn: "Technical Director—File Reference 1550-100" 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

To: director@fasb.org, File Reference 1550-100

Dear Technical Director, Board members and Staff,

The Accounting and Auditing Standards Committee of The Ohio Society of CPAs is pleased to comment on FASB Preliminary Views - Financial Instruments with Characteristics of Equity. We support the conceptual views espoused by the FASB on the basic ownership approach, noting it is a "step outside the box" from our historical approach. We favour the Basic Ownership Approach view, as proposed in the Preliminary Views document, due to it's fewest separated instruments and concept that equity or net assets is the residual interest in the assets of an entity that remains after deducting claims against the entity that reduces the residual net assets available for distribution to the holders of basic ownership instruments. We concur with the FASB that the ownership settlement approach provides an inconsistent view in practice in defining debt and equity across all instruments, and that the reassessed expected outcomes approach offers too much complexity and required separation of instruments into components to be practical for preparers and for financial statement users.

We have summarized a few concerns and areas that appear unclear in the remaining portion of our comment letter.

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?

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While we do believe the basic ownership approach would improve financial reporting, we have some concerns around the range of implementation impacts to be managed in the financial reporting process. The shift to the basic ownership approach (which the FASB supports in this Preliminary Views document) from the ownership settlement approach (which comes closest to current GAAP) will be very significant for issuers, auditors, users, educators, and other parties impacted by changes in defining and accounting for liabilities and equity.

Several areas are noted below:

- Impact on Benchmarks--This change will be seen in effect upon implementation on loan covenant agreements, ratio computations, earnings per share computations, potential merger/acquisition approaches used with reporting outcomes in mind, and in various other areas. Full retroactive application of this change in comparative financial statement presentations would seem a requirement to make any transition work well for users of those statements. Is a full retroactive application in all areas anticipated? To the extent that it is not, what additional transitional disclosures might be required?
- View of current and retained earnings--As outlined under the basic ownership approach, there is only one earnings per share computation required (basic earnings per share for a very limited definition of equity). In addition, there will be two sections of equity; one section for redeemable equity and another for non-redeemable equity, with measurement of and division of earnings (and cumulative retained earnings) between these two sections of the equity section of the financial statement of position reported. We believe elimination of historical benchmark measurements (earnings per share; book value per share, etc.) will be a major event for financial statement users and require significant reeducation as well as supporting comparative analysis and bridging on the part of issuers and financial statement users.
- Impact in tax reporting--Tax compliance and reporting may be more complicated with tax authorities (i.e. Franchise tax computations) due to a potential departure from the traditional GAAP definition of liabilities and equity. The basic ownership approach may significantly reduce equity, which is the traditional taxing base for franchise tax. How will taxing authorities respond in the use of financial information in these tax areas? We expect these authorities may act to redefine their laws in response to this redefinition of equity. In addition, within Statement of Financial Accounting Standard ("SFAS") No. 109 computations, there likely would be more permanent/timing tax differences in applying the basic ownership approach. We believe there needs to be further

guidance around whether the income changes going through the income statement from "liability instruments" should be permanent or timing differences or both in applying SFAS 109

 Increase in use of more subjective information to determine period income--paragraph 38 offers an example, whereby any debt that is callable or puttable would require management judgment to set an expected (probability weighted) settlement date. Interest expense recognition would be computed based on that expected date, with settlement before that date resulting in a recognized gain or loss. If the instrument outlives the expected probability weighted settlement date, judgment would be applied again using a new expected settlement date.

With increased levels of subjectivity required, how would these types of assumptions be effectively subject to audit review? Would this approach result in expanded opportunity to influence period earnings recognition through selective assumptions used?

Increased complexity in the financial reporting close processparagraph 39 requires an entity to reassess the classification of
every instrument at each reporting date and to reclassify if
necessary. Upon reclassification, no gain or loss would be
recognized; instead, any difference would be reported in equity.
From that point on, the instrument would be measured and reported
on under the requirements for that classification (as a liability or
equity instrument. The text goes on to say that there is no limit to
the number of times an instrument may be reclassified.

Aside from the inherent volatility in financial reporting that this reclassification process implies, the ongoing never-ending classification evaluation process required will pose challenges in practice (for both preparers and for auditors). We believe this approach will effectively increase the relative costs of financial reporting from both perspectives, and potentially will add new complexity in each period closing process.

These examples are just a few issues that need to be managed well in radically re-defining the nature of debt and equity in financial position presentation, as well as the effect of driving more "mark to market" type fluctuations through the relative measures of net income over a period of time.

We recommend that the FASB identify all major implementation issues potential to a move to the basic ownership approach, and ensure these are anticipated in the transition and execution guidance provided in this area.

We believe that implementation efforts in this change will be challenging for all financial reporting constituencies (preparers/issuers, auditors, financial statement users, tax authorities, etc.).

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 feel it will be difficult in practice to determine the classification of preferred stock and multi-class stock with a view that the "lowest level" of residual interest provides room for one equivalent class of stock as equity.

For example, what happens to companies or limited partnerships that have various classes of common stock? If an entity issues two classes of residual equity shares, A and B, with identical terms except that only the B shares receive a different ratio of distributed earnings, we believe that both classes of stock would be classified as equity if they share proportionately in the residual interest of the entity. Although the B shares have a higher proportion distribution ratio, in our view the requirement to pay a higher ratio of earnings does not subordinated A to B. We believe the intent of the preliminary views would be to treat both the A and B shares as equity and if this is not the case, this needs to be clearly stated along with the rationale for taking a different approach.

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.

We understand perpetual instruments would become liabilities and subjective judgements would be needed to fair value these types of instruments. No active market may exist, so valuation models would be necessary. Auditors would then need to become comfortable with the assumption used in these models. We believe there is a likelihood that valuations models used to fair value

perpetual instruments could result in materially different values than what might actually be paid out to a holder of the instrument in

liquidation. This might create additional litigation risk for auditors and preparers. The FASB may want to consider whether the benefit of having the fair value of perpetual instruments reported at each filing date is worth the added complexity and litigation risk created.

We also note that in paragraphs 28 and 35 (as well as Table 2), employee stock options become a "liability item" subject to periodic mark to market measurements and adjustments, which effectively will force changes over time in underlying intrinsic value through the measurements of profitability as reported in the statement of results.

In the case of employee stock options, this position in the Preliminary Views document is counter to the approach outlined in Statement of Financial Accounting Standards ("SFAS") No. 123R. Where fair value is fixed on such an instrument at the time of its grant and subsequent fluctuations in intrinsic value are driven by a multitude of non-controllable factors, does it make sense to treat such an instrument as "mark to market"?

The Company has effectively given a share of equity in return for future services when the grant is made. When this exchange effectively is fixed, does it make sense to keep re-measuring it on a "what if" basis? We believe the rationale under SFAS123R for defining employee stock options as Equity transactions and accounting for them as such was sound. Circumstances where terms/conditions would permit a change in value to be controlled by either party are well defined in SFAS123R, as well as the related consequences of being a "liability" instrument. We believe the rationale and approach under SFAS123R was correct, and should not be revised in this Preliminary views document.

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?

Adding more definition around the term "would impair the claims of any instruments with higher priority than other basic ownership instruments" would help in application. For example, more clarity is needed on whether this definition means the redemption would cause any possibility of a reduction of the amount available for any

instruments with higher priority. One approach would be to provide

an example of the type of instrument that is redeemable and could still be considered a basic ownership instrument; then, identify what

types of changes to the terms would cause the same instrument to become a liability.

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?

More clarity on how a dividend liability would be measured may be necessary. It was not clear to us whether the liability would be based on a 100% chance of the dividend being paid. Some instruments might only require a dividend in the event a common stock dividend is to be paid. It was not clear whether this type of instrument would need separation. It was also unclear when the dividend liability comes into existence. It could only exist from the ex-dividend date to the payment date. It could also be possible the definition of "require a dividend" could be based on past practice. For example, a Company that paid a dividend every year for the last 20 years may have created a constructive dividend for then next 20 years and it would be unclear when the liability separation starts and how many years of dividends it would cover.

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 instated 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?

History and management intentions such as business plans could be an additional factor not stated in the contract terms. For instance, a history of paying dividends to preferred stock holders where the contract terms do not require a dividend may indicate the instrument requires a separation. Another factor is what legal alternatives and remedies are available if a party defaults on the contract.

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?

We agree with eliminating the opportunity to choose between alternative accounting results by altering the structure of an arrangement; however there is likely to be diversity in practice in applying the "achieve an overall economic outcome that could have been achieved as simply or more simply with a single instrument" guidance of paragraph 43b. There may still be opportunity to choose between alternative accounting results by timing the instruments or finding multiple counter-parties. One potential solution could be a requirement for contemporaneous documentation of the economic substance of a transaction (similar to the documentation requirements for hedging under SFAS No. 133).

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?

Liabilities should be separated between those that will be settled in cash vs. equity. This information will be useful and relevant to assess the liquidity of a company.

In addition, we believe that full detailed disclosures will be needed on the reclassification of instruments between debt and equity definitions, and to enable a financial statement user to understand the impact of valuation changes in the statement of financial position.

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.

Interest expense should be presented separately from the impact of changes in fair value.

We believe full detailed disclosures will be needed to support users in understanding the driving forces reflected in a company's income measures, particularly what forces are driven the operations of a company versus those impacts coming from valuation and debt versus equity reclassification impacts taking place over time.

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?

The usefulness of EPS might be more limited since fewer investors will be considered equity holders.

We appreciate the opportunity to comment on this Preliminary Views document, and welcome any additional opportunity to further discuss or otherwise support the efforts of the FASB in this area.

Best Regards,

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