ILLINOIS CPA SOCIETY.

LETTER OF COMMENT NO. 52

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

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The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide its perspective on the Preliminary Views "Financial Instruments with Characteristics of Equity." The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

General Comment

Our committee believes the Board is looking for alternative definitions of liabilities and equity, and that a change in those definitions constitutes a change to the conceptual framework. For example, no definition of equity in the Preliminary Views document is true to the definitions in the existing conceptual framework. The debate over such a change is of sufficient importance that it should take place before the Board and the IASB proceed any further with this project. Until the Board revises the conceptual framework to define equity and liabilities differently, it should not entertain new standards that rely on definitions that might or might not be contained in a revised conceptual framework document.

Our comments in response to the questions raised in the document are as follows:

Questions on the Basic Ownership Approach

Question 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?*

While it is clear that limiting equity to a composition of essentially nothing but common stock is simpler, we do not agree that it is an improvement. However, various members of our committee have different reasons for the conclusion that the basic ownership approach is not an improvement. Some members believe the definition of equity embodied in paragraph 62 of FASB Concepts Statement No. 6 must be considered. That is, they believe it conceptually correct that "...some classes of owners may bear relatively more risks..." than other classes of owners and believe that any operational definition of equity should adhere to that concept. Others believe that the basic ownership approach takes a form over substance view of what is equity.

While all our members agree that equity is a residual claim, they differ as to the operational nature of that claim. Some members of our committee focus on whether the holder of the claim is in a position to require distribution of assets absent liquidation. They would point to the definition of a liability as requiring a present obligation to distribute assets or provide services and note that a preferred perpetual instrument, though it is a fixed claim to assets, is still not entitled to obtain those assets absent a declaration from the entity's board. They would note that defining equity to be only the claims of those who are last in line in liquidation ignores the concepts set forth later in that same paragraph of Concepts Statement No. 6. That is, in entities presumed to be going concerns, equity should comprise all those claims that have no rights "to receive future transfers of assets except in liquidation, and then only after

liabilities have been satisfied". Reducing the definition of equity to that described in the Basic Ownership Approach appears to abandon a going concern assumption in favor of a liquidation basis assumption.

Others believe the important economic distinction between debt and equity is whether the ultimate claim is fixed by the terms of the agreement or varies with the total available at liquidation. They believe a residual claim is not just a claim that is not paid until liquidation, but also one where the amount to which the claimant is entitled depends on the amount of assets to be liquidated. From that perspective, barring financial distress, a preferred stock claim is very much like a debt claim, the only difference between them perhaps being existence of a maturity date and some tax consequences. Although preferred stock may be equity in the legal sense, from the perspective of common shareholders of a healthy firm, it is more like a liability. They note that when a firm is under financial distress, preferred stock (or even debt) may be viewed as the residual, because the range of possible liquidation values is such that the value of the claim does vary with the value of the assets. They believe this model is simpler but does not represent an improvement over existing reporting. It excludes from equity any claims that are economically similar to equity but that are not actually shares. Therefore, it takes a form over substance approach that is not only inappropriate in financial reporting but is also likely to lead to the development of securities for the purpose of achieving accounting results that are inconsistent with the underlying economics.

Our committee agrees that the Board must address conceptual issues regarding the nature of liabilities and equity and the meaning of residual interest before proceeding with the details in the Preliminary Views document. Then, its work should be guided by the conceptual framework including revisions, if any, that arise from its work.

Perpetual Instruments

Question 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?*

Some of our members believe that perpetual instruments that do not have a stated maturity date and whose claims to receive distributions of assets are only strictly enforceable upon liquidation should not be given the status of liabilities. They do not meet the definition of a liability as there is no present obligation to transfer assets or provide services. To display them otherwise is misleading.

Others believe that whether an instrument is perpetual should not determine whether it is equity. They believe the issue is whether the instrument represents a residual interest. As the preferred stock example illustrates, a perpetual interest may not represent a residual interest.

Question 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.*

It is unclear to us how a "liability without settlement requirements" meets the definition of a liability. We have a particular concern that the Basic Ownership Approach, in its quest to make the equity section easy to compose, will so confuse the definition of a liability as to make that section of the financial statements meaningless.

We are also concerned with the continued presumption that all things can be measured at fair value. The confusion engendered by the accounting model related to securitized assets and the absence of any meaningful way to account for auction rate securities are but two examples of the potential harm done by forcing all financial instruments to be recorded at fair value when there are no markets for those instruments.

Whether the value of such an instrument should be remeasured should be consistent with the treatment of other liabilities. However, option (c) is inappropriate in that there is no reasonable basis for determining an estimated retirement date. Further, estimating the value of the security where the valuer is permitted to assume an arbitrary retirement date is likely to lead to manipulation of the measurement.

Redeemable Basic Ownership Instruments

Question 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 disagree with an approach that applies liquidation basis accounting concepts to a going concern. There is no more reason to value perpetual instruments on a liquidation basis than there is to value pension obligations on a liquidation basis; entities that are going concerns should follow an accounting model that reflects that concept. Compliance with criterion (a) is difficult because it requires an estimate of the amount at which the firm could be liquidated. In that sense it is not operational. However, it is probably no more infeasible to determine that value than many other values required by GAAP.

We believe that a Basic Ownership Instrument that is redeemable at the option of the holder should remain an instrument classified as equity until such time as the holders of those instruments call for the distribution of the net assets to which they are entitled. These arrangements are typically found only in small, family owned businesses and their exercise results either in a valuation of the business and the settlement of that claim at proportionate fair value or, if assets are not sufficient to satisfy the claim, the liquidation of the business. In the former case, any lenders involved understand the nature of these arrangements and their implications. In the latter case, the redeemable interests are settled along with all other Basic Ownership Interests and the holders of those instruments are not able to obtain assets otherwise distributable to creditors.

Separation

Question 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?*

We believe the classification of dividend claims related to those that have been declared is currently appropriate: they are current liabilities as they represent present obligations to transfer assets. We do not believe there's a requirement to bifurcate a Basic Ownership Interest into a "principal" component and a "required dividend" component unless that required dividend component has the claim status of the company's creditors. That is, until declared, those dividends remain residual interests and should be accounted for as such.

There may be circumstances that would preclude payment of the dividend even if required under the terms of the instrument, namely adequate financial performance such that the dividend would be allowable under state law and any debt agreements that restrict dividends. However, the instrument itself, as opposed to the dividend, is not a liability because until the conditions that allow payment of a dividend are met and the dividend is declared, there is no liability. We don't believe separation provides any useful information for investors beyond current practice.

Substance

Question 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?*

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As stated previously, a number of our members believe the Board should look to the Conceptual Framework in its consideration of the substance of financial instruments with the characteristics of equity. Perpetual Instruments – those that cannot force settlement in the absence of liquidation – are residual interests and should be so recorded. For example, a preferred stock that gives the holder the right to force cash redemption on demand is no different from a debt instrument with that same right. A preferred stock that accumulates dividends but that cannot force cash to be distributed is a residual interest; though one that has standing ahead of a Basic Ownership Interest. They believe the substance of equity is its residual claims nature.

The substance requirement highlights the inadequacy of the basic ownership approach as described in the Preliminary Views. If the approach were conceptually sound, all instruments that were equity in substance would be captured by the definition of equity. In fact, some of our members believe that application of the substance requirement should lead to a definition of equity as embodied in the REO approach. The description of the REO underlying principle is that "an entity would classify instruments based on the nature of their return and their settlement requirements (or lack thereof)." They interpret "nature of return" to mean an instrument behaves like equity, regardless of whether it is legally an equity instrument. That is, it goes to substance.

Linkage

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

While we do not foresee any circumstances in which the linkage principle would not result in classification that reflects the underlying economics, we believe that consideration of the substance of an instrument as described above should be all that is necessary. A contractual arrangement that gives the parties to that arrangement the right to force the distribution of assets apart from liquidation is "a present obligation to transfer assets or provide services" and should therefore be recorded as a liability. Attempting to provide ever finer definitions of liabilities and equities is not consistent with an approach that seeks to reduce the complexity of financial reporting. If the Board believes there are instruments currently classified as equity that do not meet the current definition of equity, that may represent an enforcement issue rather than a standard setting issue.

Measurement

Question 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?*

Consistent with our comments above, instruments that only have residual claims should be classified as equity. We do not necessarily believe that derivative instruments should be carried at fair value if those instruments have only residual claims; to do so is to record a small portion of residual claims at "fair value" when residual claims in total are not so valued. We are not advocating the presentation of the entire balance sheet at fair value as we do not believe that is either practical or warranted. We believe that derivatives that are linked to the company's own stock should not be measured at fair value. These instruments (or components of them) are equity and should be treated as such.

Presentation Issues

Question 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?*

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We do not agree with the Basic Ownership Approach. We question whether liabilities that can only be settled by issuing residual interests are in fact different from residual claims. If they have no priority of claim over Basic Ownership Interests or Perpetual Interests, it is not clear why they should be classified outside of equity.

Generally, the amount and timing of settlement is important, but the form of settlement is not. Requirements to issue cash or securities can always be unwound with concurrent transactions to issue or repurchase securities. The form of settlement would only take on meaning for a firm that does not have adequate access to capital markets, such as a firm in financial distress. It may make sense to limit the expanded disclosure contemplated in this question to such entities.

Question 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.*

It is not clear to which instruments this question is referring. To the extent that an instrument is classified as equity, changes in its value should not be recognized in the financial statements. To the extent that an instrument is a liability, changes in value should be recognized in the same fashion as changes in values of similar liabilities. For example, an instrument (or portion thereof) classified as debt should have amortization of premium or discount associated with it recognized as part of interest expense.

Earnings per Share

Question 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?*

Consistent with our comments above, Basic Ownership Interests that have redemption requirements should remain as equity instruments until such time as a settlement claim is made manifest. Other Perpetual Instruments are dealt with appropriately in the current EPS model in arriving at earnings applicable to Basic Ownership Interests. EPS should be defined in a manner that is consistent with the definition of equity.

Questions on the Ownership-Settlement Approach

Question 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 classifications of instruments under the Ownership-Settlement Approach are closer to the classifications that arise when applying the principles set forth in Concepts Statement No. 6. Those classifications are also more closely aligned with IFRS, as shown in the IASB's Discussion Paper issued in February, 2008.

Instruments that represent residual claims should be recorded in equity and our committee does not see the need to report some residual claims at "fair value."

Some committee members believe an instrument should not be considered equity due simply to its being a perpetual interest. They believe an instrument is equity if it is a residual interest (whose claims to assets vary with the entity's performance) or is economically similar (in terms of risks and returns) to a residual interest. However, this position is a departure from Concepts Statement No. 6.

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

We believe that only components that have claim status above that of residual claims need to be separated. That is, a perpetual or indirect claim that has embedded in it a right to force the distribution of assets other than via liquidation should be bifurcated so as to record that embedded right as a liability based on the concept that it meets the definition of a liability. Features that merely shift holders among different risk classes of residual claims should be disclosed, consistent with current practice. Finally, it is not obvious that this approach is substantially more complex than the basic ownership approach.

Substance

Question 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 that the definition of a liability should guide the Board in this area. A holder's ability to force cash settlement as described appears to meet the definition of a liability and should be so classified. Attempts to provide ever finer definitions of these arrangements are, we believe, unnecessarily complicating. If the instrument provides the holder more than a remote ability to force cash settlement, it is, in substance, a liability and that substance should govern preparers.

The discussion at paragraph A40 is unnecessarily complex and off the mark. The form of settlement is irrelevant to the economics of an instrument except in specific circumstances when an entity does not have adequate access to capital markets. Thus we believe that the discussion makes a complicated matter of something that is not particularly important.

Presentation Issues

Question 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?*

We believe the questions are best considered in terms of claim priority. Our members who believe a "liability" that is settled by the issuance of a residual claim is, in substance, a residual claim and should be classified as equity. Those that can be settled by compelling the entity to transfer assets or perform services meet the definition of a liability and should be so presented.

All our members believe there is no need for additional disclosure on the face of the balance sheet. However, timing and form of payment should be disclosed in the notes.

Separation

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

We believe the requirements are operational. The information is valuable because it is based on the substance of the instruments, not the form.

Earnings per Share

Question 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?*

EPS should be defined in a manner that is consistent with the definition of equity.

Settlement, Conversion, Expiration, or Modification

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

While we believe the requirements are operational, our comments above are applicable. Changes in assets and liabilities are certainly candidates for inclusion in earnings; changes in residual claims should remain in equity. As stated previously, we continue to express concerns over the Board's apparent assumptions that fair value is always better and that it is reliably determinable. We understand and agree that fair value information is relevant, but as that information becomes less and less reliable, we do not believe its relevance remains untainted.

Questions on the REO Approach

Questions 1 to 3 –

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.*

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

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?*

Our committee does not believe this approach is an improvement or that it is appropriate for the vast majority of businesses in the U.S., which are not public entities. Many of those entities issue preferred and other perpetual interests as permitted under state laws often for estate planning or tax purposes. Those instruments are not issued for the same purposes as they are for public entities. The complexities of the REO approach outweigh the costs to implement it.

Some of our members believe the REO approach is an improvement and operational for public firms. They believe that a firm would only issue a security if it understood the nature of returns and risks associated with that security and that the appropriate classification should not be unduly burdensome. But again, these members note that the REO approach is inconsistent with Concepts Statement No. 6.

Other Alternatives

Question 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?*

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We believe the Board and the IASB should be guided by their respective conceptual frameworks. We also believe *both entities should move slowly when addressing areas of financial reporting that are so familiar to users and have* been the standard for generations. While we applaud both boards' efforts to improve financial reporting, we believe those improvements should be viewed in a broad historical context and not radically depart from long established practice solely for the sake of change.

We appreciate the opportunity to offer our comments.

Sincerely,

John Hepp, CPA
Chair, Accounting Principles Committee

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APPENDIX A

ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2007-2008

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:

Large: (national & regional)

Name	Affiliation
John A. Hepp, CPA	Grant Thornton LLP
Alvin W. Herbert, Jr., CPA	Retired/Clifton Gunderson LLP
Steven C. Johnson, CPA	McGladrey & Pullen LLP
Matthew G. Mitzen, CPA	Virchow Krause & Company, LLP
Laura T. Naddy, CPA	Crowe Chizek and Company LLC
Reva B. Steinberg, CPA	BDO Seidman LLP
Jeffery P. Watson, CPA	Blackman Kallick LLP

Medium: (more than 40 employees)

Name	Affiliation
Barbara Dennison, CPA	Selden Fox, Ltd.
Marvin A. Gordon, CPA	Frost, Ruttenberg & Rothblatt, P.C.
Ronald R. Knakmuhs, CPA	Miller, Cooper & Co. Ltd.
Laurence A. Sophian, CPA	Ostrow, Reisin, Berk & Abrams, Ltd.

Small: (less than 40 employees)

Name	Affiliation
Walter J. Jagiello, CPA	Walter J. Jagiello, CPA
Kathleen A. Musial, CPA	BIK & Company LLP

Industry:

Name	Affiliation
John M. Becerril, CPA	Cabot Microelectronics
Melinda S. Henbest, CPA	The Boeing Co.
James B. Lindsey, CPA	TTX Company
Anthony Peters, CPA	McDonald's Corporation

Educators:

Name	Affiliation
James L. Fuehrmeyer, Jr. CPA	University of Notre Dame
David L. Senteney, CPA	Ohio University
Leonard C. Soffer, CPA	University of Chicago

Staff Representative:

Name	Affiliation
Paul E. Pierson, CPA	Illinois CPA Society