



**PCPS**

PRIVATE COMPANIES PRACTICE SECTION



LETTER OF COMMENT NO. 61

June 6, 2008

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**Re: November 30, 2007 FASB Preliminary Views, *Financial Instruments with Characteristics of Equity***

Dear Mr. Golden:

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 Preliminary Views (PV) and is providing the following comments for your consideration.

#### GENERAL COMMENTS

TIC applauds the FASB for its efforts in this PV to resolve current practice issues concerning financial instruments with equity characteristics and for adopting a principles-based approach that emphasizes transparency and simplicity.

TIC unanimously supports the general principles of the Basic Ownership Approach presented in the PV. However, TIC members were unable to reach a consensus regarding the classification of certain stock options under this approach. Some TIC members believe the Basic Ownership approach should support equity classification for stock options settled with basic ownership shares. Other members support liability classification for such instruments.

In addition, TIC could not unanimously approve one method for the subsequent measurement of perpetual instruments classified as liabilities. However, most TIC members see no cost/benefit in remeasuring perpetual instruments classified as liabilities at fair value.





TIC also believes the PV (and eventual exposure draft) needs to be expanded to address the unique liability/equity arrangements found in limited liability companies (LLCs) and limited liability partnerships (LLPs).

Further details regarding the above comments are provided below.

## **SPECIFIC RESPONSES TO 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?*

Yes, TIC unanimously supports the general principles underlying the Basic Ownership Approach. The current model for distinguishing the equity characteristics of financial instruments is very complex, inconsistently applied and often leads to structured transactions. The Ownership-Settlement Approach is very similar to the existing accounting model and will therefore do little to improve financial reporting.

In contrast, the premise of the Basic Ownership Approach is that capitation of the risks or rewards of ownership creates a financial instrument that has different characteristics than an equity instrument and that such differences should be recognized as the entity's liabilities on the financial statements. The Basic Ownership Approach is more consistent with the intent and purpose of private company capital transactions.

The Basic Ownership Approach would simplify the accounting for the instruments that fall within the scope of the PV, since the need for complex bifurcation of financial instruments would be reduced. The characteristics that distinguish liability and equity instruments are clearly stated and should significantly reduce the opportunities for structured transactions. TIC also agrees with the statement made in the PV that accounting simplification will also improve the comparability of financial statements.

### **"Plain Vanilla" Stock Options**

However, TIC members could not reach a consensus on the application of the Basic Ownership Approach to the classification of "plain vanilla" stock options that require settlement in the form of basic ownership instruments, and many foresee practical





difficulties in classifying them as liabilities.

“Plain vanilla” stock options give the holder the right to purchase a certain number of shares of basic ownership interests for a predetermined price for a specified period of time and have no other preferential features. The options would expire if unexercised. Generally, TIC members included stock-based compensation within the scope of plain vanilla stock options as long as the option terms were as defined above.

TIC members who believe the options should be classified as equity reject the Board’s argument in paragraph 68 of the PV, which states that issuing the new shares for a price less than fair value (i.e., the exercise price) would reduce each existing holder’s share of the entity’s assets. In their view, this argument doesn’t apply since upon exercise, newly issued shares would be classified as residual equity. Such options are not superior to common shares if they can be settled only with common shares that have no higher priority than shares held by current residual stockholders. In fact, some of the existing shareholders may have acquired their shares at option prices but will receive the same value in liquidation as a shareholder that paid full price for the shares. They therefore believe that the options meet the criteria for a basic ownership instrument discussed in paragraph 18 of the PV.

Some also expressed concern that nonpublic entities would incur higher valuation costs under the PV if remeasurement of the option liability in future periods had to be based on fair value, rather than the intrinsic value method permitted under FASB Statement No. 123R, *Share-Based Payment*. Based on the above points, TIC members who favor equity classification believe the PV should be revised accordingly.

Other TIC members who believe the options should be classified as liabilities agree with the liability arguments in the PV and believe all options are obligations that should be classified as liabilities.

### **Equity Interests in LLCs and LLPs**

TIC is also concerned that the PV may not be operational as written for many complex LLC/partnership arrangements. Appendix C, Table 2 (page 46), indicates that a general partnership interest would be classified as equity under the Basic Ownership Approach. TIC believes this assumption is an oversimplification, since classification will vary based on the specific terms of LLC/LLP agreements.

Some TIC members have LLC/LLP clients whose equity arrangements are very complex and bear no relationship to a typical corporate structure. In such entities, the general partner





may or may not be the holder of the most residual interest in the entity. In fact, given the complexity of many of these arrangements, TIC finds that determining the residual interest holders under the Basic Ownership Approach may be almost impossible.

### Example 1

One TIC member has found that the most prevalent financing structure for the development and management of mixed-use developments (low-income housing and retail stores) in his geographic area is the formation of real estate LLCs or LLPs at the federal, state and local levels. These entities are totally tax driven and frequently have very complex ownership agreements that involve many interrelated entities. They generate positive cash flow from operations but have paper losses. The project is occasionally impaired from the first day it is placed in service. The entity is dissolved once the tax benefits to the investors are exhausted. At that point, there is generally no residual interest to be distributed, although uncommonly a few projects generate small upside returns. The general partner, who is usually the developer, generally has a very small equity interest (such as .01%) in the LLC/LLP and receives fees during the construction period.

The GP may have preference over any upside returns (which are uncommon) or may share pro rata with other investors. The largest limited partner (with, for example, a 99% equity interest) is generally a large bank or insurance company that receives tax credits as a result of its investment and benefits from a large percentage of the passive losses generated by the LLC/LLP. Other limited partners own small fractions of the entity and in turn receive the right to federal and/or state tax credits in exchange for their investments. (Government regulations often require that an investor in the project be an owner to qualify for the tax credits.) This example illustrates the potential complexities surrounding the general and limited partners' interests. TIC encourages the Board to revise the table in Appendix C to better accommodate the varying arrangements within LLCs/LLPs.

### Example 2

Another TIC member reported that his firm often sees LLCs formed by venture capitalists and private equity investors who are seeking maximum return on their investments. A typical agreement includes various classes of membership and distribution schemes that are designed to provide gradations of risk among the various investors, with the highest rewards going to the investor(s) with the greatest risk. Within each membership class, there are so many rights and obligations that it is virtually impossible to determine who has residual equity interests, if anyone. Each agreement contains a waterfall of distributions.





TIC is uncertain how these arrangements would be evaluated under the Basic Ownership Approach and requests that the Board provide application guidance. Specifically, TIC recommends that future exposure drafts and the final standard acknowledge these financing structures, address liability/equity decision issues for these types of business entities and provide specific examples or guidance for implementing FASB's preferred approach.

### *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?*

TIC supports the theory presented in the Basic Ownership Approach for the classification of perpetual instruments. However, most TIC members have practical concerns regarding the fair value method (paragraph 34[b]) for the subsequent measurement of perpetual instruments. See the answers to Questions 3 and 8 below.

*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.*

TIC reached a consensus that it could not support the alternative proposed in paragraph 34(b), which would re-measure perpetual instruments that are classified as liabilities at fair value with changes reported in income. Perpetual instruments, such as preferred stock, are not derivatives. TIC members who oppose remeasurement of preferred stock at fair value compare preferred stock to other basic debt instruments, such as bank loans. Since bank loans are not remeasured at fair value, they believe remeasurement is also inappropriate for preferred stock.

Most TIC members agree that the better method, as presented in paragraph 34(a), is to report dividends as an expense. The dividends should be accrued as liabilities based on a coupon without regard for when the dividend is declared or paid. If the perpetual instrument has a conversion feature, the feature would be discounted out and annual accretion would be recognized in the income statement.

*In addition, paragraph 34(a) is clearly the most practical of the three approaches presented in*





that it will reduce the need for expensive valuation specialists and is consistent with the Board's objectives of simplicity and transparency. For nonpublic entities, fair value remeasurement of perpetual instruments classified as liabilities will involve Level 2 or Level 3 inputs. As a result, periodic remeasurement will add a cost burden that cannot be justified by user needs, since users are not requesting fair value information for such instruments.

It should be noted that at least one TIC member prefers the mark-to-market approach on theoretical grounds in all cases. Another TIC member believes that preferred stock without dividends should be remeasured at fair value, but would support the accounting in paragraph 34(a) for preferred stock with dividends.

### *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?*

Yes, TIC believes the criteria are operational and believes re-measurement of redeemable equity is a reasonable alternative to liability classification.

The criteria in paragraph 20 are very different from current practice, where the redemption feature does not take into account any liquidation amounts and does not consider whether other claims would be impaired. The criteria in paragraph 20 require that the redemption amount would be the same as the share of the issuer's net assets that the holder would receive if the entity were to liquidate on the classification date, and the terms of the instrument prohibit redemption if redemption would impair the claims of any instruments with higher priority than other basic ownership instruments. TIC believes the advantage of the new approach is that those instruments that should be classified as liabilities would be readily identified. For example, the new criteria appropriately and clearly exclude holders of preferred stock with priority claims from equity classification.

However, to ensure that paragraph 20 is consistently applied in practice, TIC recommends that the language in the paragraph be written in plainer English to promote greater understanding of the criteria. While TIC understands that all classification conditions need to be addressed, the basic classification objective and concepts of paragraph 20 should be presented first. Paragraph 20 should include a general statement similar to the following:

*Mandatorily redeemable basic ownership interests and nonredeemable basic ownership interests are both classified as basic equity because (describe*





common characteristic(s) that distinguish them from ownership interests that should be classified as liabilities).

Perhaps, paragraph D14 of the PV could be moved to paragraph 20 to clarify the Board's intent.

TIC believes it is especially important that guidance for redeemable basic ownership instruments be sufficiently clear so as to differentiate how the new standard will differ from SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*. Perhaps, examples could be used to illustrate specific arrangements that would/would not qualify as basic ownership instruments.

### ***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?*

TIC agrees that a basic ownership instrument with a required dividend payment should be separated into liability and equity components, with the dividend being an obligation of the entity to be paid in cash or to deliver common stock. Reporting the dividend obligation as a liability would provide useful information.

### ***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 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?*

Under the basic ownership approach, there are distinct lines as to what is an equity instrument. The substance principle is not necessary under this approach because there should be no factors or circumstances that could change an instrument's classification or measurement other than the stated terms of that instrument. Therefore, there may be occasions when the basic ownership approach dictates classification of an instrument that is not consistent with its economic substance. Paragraph 44 discusses two principles that could affect the classification and separation, which are based upon the concept of "remote" in FASB Statement No. 5, *Accounting for Contingencies*. TIC believes such principles would lead to a rules-based approach rather than a principles-based approach to classification.

### ***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?*

TIC is not aware of any circumstances where application of the linkage principle would lead to a classification that would not reflect the economics of the transaction. This principle is needed to prevent structuring of transactions.

### ***Measurement***

*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?*

One of the practical difficulties of the Basic Ownership Approach for nonpublic entities is that fair value measurements will become more prevalent. Most TIC members believe fair value remeasurement should be limited to the extent possible to reduce complexity when fair values are not deemed essential by financial statement users. TIC's specific concerns on this issue were discussed within the answer to Question 3.

### ***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?*

To achieve more transparent reporting, TIC believes liabilities required to be settled with equity instruments should be reported separately from those required to be settled with cash. TIC believes creditors will be especially interested in those liability instruments that will be cash settled.

*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.*

TIC believes that changes in fair value should be reported separately from interest expense on the income statement. It is important to the user of the financial statements to be able to determine the noncash expense caused by the change in fair value of a financial instrument. However, as stated above, TIC generally believes fair value measurements should be held to a minimum.

## OTHER COMMENTS

### Classification Examples—Item 1 (Common Share), Footnote 10, page 46

TIC recommends that Footnote 10 be revised to include the phrase “or other preferential feature” at the end of the second sentence. The example should not give the impression that liquidation preferences would be the only feature that would distinguish two classes of common stock.

### Restricted Stock

TIC suggests that guidance be added for the classification of restricted stock, including presentation in the table of classification examples in Appendix C. The guidance should





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clarify that restricted stock would be classified as either liability or equity based on the share class to which it is attached. For example, restricted preferred would be a liability; restricted common would likely be equity.

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 Bodine, Chair  
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committee

