

# NORTEL

May 30, 2008

Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116



LETTER OF COMMENT NO 37

File Reference No. 1550-100

Re: Preliminary Views on "Financial Instruments with Characteristics of Equity"

Dear Technical Director:

Nortel Networks Corporation (Nortel) appreciates the opportunity to comment on the Financial Accounting Standards Board Preliminary Views on "Financial Instruments with Characteristics of Equity." Nortel supports the Board's attempt to improve the usefulness of information to investors and to develop a global standard in conjunction with the International Accounting Standards Board.

Nortel is a global supplier of communications equipment, software and services, serving both telephone service provider and business and governmental enterprise customers, with over \$10 billion in revenues. While we are headquartered in the Greater Toronto Area, our securities are traded on the New York Stock Exchange (in addition to the Toronto Stock Exchange), we follow accounting principles generally accepted in the United States of America, and we file Annual and Quarterly Reports on Forms 10-K and 10-Q with the Securities and Exchange Commission. We currently have various types of ownership instruments, including convertible debt and stock compensation, which could possibly be affected by a new accounting standard.

The body of this letter includes our general comments and observations on the Preliminary Views. Appendix A to this letter includes our responses to the specific issues raised.

## Preferred Approach

Of the approaches set forth, we prefer the Ownership-Settlement Approach (OSA), which would require less cost to implement while continuing to present the financial statements in a manner most investors have come to recognize and understand. The OSA also provides the benefit of closer alignment with IAS 32, making convergence more likely to be accomplished in an efficient manner. We support the continuing efforts of the Board and the IASB toward alignment of guidance for financial instruments.

We do not believe that the Basic Ownership Approach (BOA) generally results in classification consistent with the economic substance of instruments as, in our opinion, instruments to be settled by the issuance of equity shares should be measured at fair value on the date they are issued, and classified in equity thereafter, so long as they do not have a claim on the assets of an entity any greater than holders of the equity instruments issued in settlement. We believe that such a significant departure from the current view of classification and measurement of income under US GAAP as would occur under the BOA is not warranted.

## Stock Compensation

As inferred by our preference for the OSA, we would oppose liability classification of employee stock options that will be settled in equity shares. We believe the dilutive impact of such instruments is best reflected as an adjustment of the denominator in EPS presentation and that changes in the value of an entity's equity subsequent to the date stock options are granted represent the benefits that are accruing to an option holder as an owner of the entity and do not bear any relationship to the operations of the entity, results of which are traditionally represented in the income statement. We believe these same arguments apply to other equity derivatives which is a fundamental reason we support the OSA rather than BOA.

It was also unclear to us how the BOA would be applied to stock compensation instruments other than options. For example, would a non-vested share be presented as a liability because the holder does not have a current claim on the residual assets of the entity? If no, what is the conceptual reasoning for classifying a non-vested share as equity while classifying an option as a liability when both represent potential claims that would dilute the claims of other basic ownership instrument holders?

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We appreciate the opportunity to comment on the proposed Preliminary Views. If you would like to further discuss any of our comments, please do not hesitate to contact me at (905) 863-3653 or <a href="mailto:pkarr@nortel.com">pkarr@nortel.com</a>.

Sincerely,

Paul W. Karr

Controller

Nortel Networks Corporation

and Whar

C: Paviter S. Binning, Executive Vice President and Chief Financial Officer

#### APPENDIX A

# Questions on the Basic Ownership Approach

Issue 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?

We agree that the BOA would simplify accounting for certain instruments and would provide minimal structuring opportunities. However, we believe it is the goal of financial reporting to be representationally faithful, and reflective of an understandable principle, not to eliminate all possible structuring opportunities. We encourage the Board to explore other methods of enhanced presentation and disclosure to address its concerns about potential structuring.

We do not believe the BOA would represent an improvement in financial reporting. Our concerns include:

- The costs necessary to apply the BOA, including costs to create current statements, adjust historical statements, and amend various other legal documents (i.e., amend debt covenants or obtain waivers) may not be justified by the incremental usefulness to investors.
- The financial statement presentation under the BOA would differ sufficiently from current practice such that it may encourage the proliferation of non-GAAP financial measures, which would undermine consistency between preparers. These developments around additional non-GAAP disclosures would create additional costs in time and money for preparers.
- The BOA would introduce significant earnings volatility that bears little or no relationship
  to the direct business operations of an entity, as further described in the issue on
  measurement below.

## Perpetual Instruments

Issue 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 don't believe the proposed classification of perpetual instruments under the BOA would lead to non-compliance with our existing debt covenants, however we believe the classification of perpetual instruments as liabilities has the potential to impact debt covenants and other financial metric-related criteria for other preparers, which may require preparers to renegotiate existing financing agreements in an unfavorable debt market, resulting in incremental costs to shareholders.

Issue 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.

Nortel has perpetual preferred stock which is redeemable at a fixed redemption premium. Of the potential subsequent measurement requirements discussed in paragraph 34, we believe option (a.) is most appropriate as it reflects the economic substance of the financing transaction.

We believe the application of option (b.), which requires the perpetual instrument to be remeasured at fair value, is not appropriate since such fair value would not be representative of the ultimate outcome to the issuer (i.e., redemption of the security if a decision is made not to hold to perpetuity). Option (c.) suggests present valuing the redemption price and the expected dividend stream, which we believe is not appropriate for the same reason. In addition, option (c.) would result in effectively recognizing the dividends before they are earned (cumulative dividends) or declared (non-cumulative dividends). Also, option (c.) introduces additional subjectivity in measurement with the need to determine an expected retirement date.

# Redeemable Basic Ownership Instruments

Issue 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?

Currently, Nortel has no redeemable basic ownership instruments.

## Separation

Issue 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?

Currently, Nortel has no basic ownership instruments with required dividend payments. However, it would also be useful for the Board to clarify their intent regarding the appropriate accrual pattern for required dividends.

## Substance

Issue 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?

We are not aware of any unstated factors that could affect an instrument's classification under the BOA. However, we do not believe that the BOA generally results in classification that is consistent with the economic substance of the instrument as, in our opinion, instruments settled in shares should be considered as equity, not a liability, since the outcome is equity.

It is our understanding that the purpose of the BOA is to "draw a line between the different types of claims to an entity's net assets" as stated by the Board in paragraph 52 of the Preliminary Views. We believe the definition of basic ownership instruments draws such a line. However, inclusion of the substance principle permits the use of preparer judgment in classification, leading to a blurring of that line. Judgment, even when applied to faithfully represent the economics, increases complexity and may provide increased possibility of structuring opportunities which necessitates continuing clarification from the Board. The substance example the Board provided indicates that the warrant holder has "virtually identical" claim to that of a common shareholder; however, the holder is not a current owner and the instrument is not characterized by paragraph

18. The example applies qualitative, unstated factors in order to make the classification representationally faithful. We believe this example is supportive of classification of certain indirect ownership instruments, settled in basic ownership instruments, as equity. Therefore, we believe inclusion of the substance principle, while beneficial and supportive of our own views on classification, better aligns with approaches other than the BOA.

#### Linkage

Issue 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 believe application of the linkage principle requires professional judgment to adequately evaluate both the form and substance of the transaction. Paragraph 42 indicates the intent is to "eliminate" structuring opportunities; however, subsequent interpretation and application of the principle in practice may not achieve the desired result in all circumstances (similar to application of AICPA Technical Practice Aid 5100.39 concepts). In the Board's straight-forward example, only one day lapses between the issuance of separate instruments; however, the concepts in paragraph 43 b. regarding "entered into at or near the same time" and outcomes that could be achieved "more simply with a single instrument" could be subjective given the complexity of some financial instrument structures and the preparer's knowledge of them. With respect to reflecting the economics, we believe the principle generally would do so, but there could be exceptions. It may be possible for a particular entity, during certain market conditions, to issue separate instruments 30 to 60 days apart that together achieve an overall desired economic outcome, but account for the instruments as separate transactions. Also, an entity may choose to assume some incremental risk by structuring transaction components to involve unrelated counterparties and with an absence of contractual linkage of the obligations.

#### Measurement

Issue 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?

We do not believe it appropriate to reflect those changes in fair value through net income. The increased number of such instruments would increase the volatility of results despite the fact that the instruments will actually settle in equity shares and not cash.

Also, although many sophisticated analysts will take these volatility amounts into effect (i.e., by backing them out), we can not be certain all investors will understand the changes, which could lead to a circular affect on the relationship between stock price and net income. For example, as the stock price increases, Nortel's liability would increase, thereby decreasing net income. A decrease in net income commonly leads to a decrease in the stock price, which would lead to a decrease in the liability, thereby increasing net income. This circular pattern is possible despite the lack of any changes in operations or financing on the part of the Company.

## Presentation Issues

Issue 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?

We believe it would be appropriate to separate liabilities settled in cash from those settled in equity in order to provide more information about potential cash requirements and future

movements in the equity section of the balance sheet. We believe such information should be presented on the face of the balance sheet. We believe additional guidance would be required on classification for instruments that may be settled in cash and/or equity.

Issue 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.

We believe that the any such affects on net income should be disaggregated and displayed separately in order to provide readers with more information on the source and size of any volatility. We agree with the suggestion that interest expense and unrealized gains and losses should be displayed separately. This would allow readers of the financial statements to more ably isolate the non-operational causes of volatility.

# Earnings per Share (EPS)

Issue 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?

We look forward to the opportunity to comment on the EPS guidance after further deliberation by the Board.

# Questions on the Ownership-Settlement Approach

Issue 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.

We believe the Ownership-Settlement Approach (OSA) is preferred over the BOA because it would require less cost to implement while continuing to present the financial statements in a manner in which most investors have come to recognize and understand. The OSA also provides the benefit of closer alignment with IAS 32, making convergence more likely to be accomplished in an efficient manner.

It is the goal of financial reporting to be representationally faithful, and reflective of an understandable principle, not to eliminate all possible structuring opportunities. We believe that the OSA appropriately incorporates stated and unstated factors in classification to reflect the substance of the instruments. Also, classification of instruments in a similar manner to existing guidance reflects consistency with the FASB Concept Statements regarding elements of the financial statements.

Issue 2: Are there ways to simplify the approach? Please explain.

The Board should provide as much clarity as possible regarding identification of a comparable freestanding non-equity instrument for initial valuation and measurement of a non-equity component.

We believe a significant part of the complexity that arises under the current approach stems from the lack of a cohesive, comprehensive description of the current guidance. The Board should endeavor to codify the guidance and tweak it as considered necessary, instead of rewriting the fundamentals.

#### Substance

Issue 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 the principle would be operational; however, some additional clarification could be provided on identification of "substantive settlement features". Are there certain qualitative or unstated factors that should or must be considered? Does historical ability to settle in a certain manner have bearing?

#### Presentation Issues

Issue 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?

As stated above, we believe it would be appropriate to separate liabilities settled in cash and those settled in equity in order to provide more information about potential cash requirements. However, under the OSA, we believe the information should be disclosed in the footnotes. This information would also be needed to help users better determine future movements in the equity section of the balance sheet. We would appreciate additional guidance on classification for instruments that may be settled in cash and/or equity.

#### Separation

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

We believe the separation may be useful to financial statement readers because it shows the true financing cost of the liability component.

# Earnings per Share

Issue 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?

We look forward to the opportunity to comment on the EPS guidance after further deliberation by the Board.

#### Settlement, Conversion, Expiration, or Modification

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

The requirements described in paragraphs A35-A38 appear operational, but we would request examples of possible transactions before concluding on either the operationality or usefulness to financial statement users.

# Questions on the REO Approach

We agree with the Board's conclusion that the complexity and cost of the REO Approach outweighs any potential benefits.