Preliminary Views on Financial Instruments with Characteristics of Equity

Dear Ms. Bielstein:

UBS appreciates the opportunity to comment on the Preliminary Views on Financial Instruments with Characteristics of Equity ("the PV document"). UBS is a global financial services firm that issues and structures equity-based financial instruments. Our consolidated financial statements are prepared in accordance with International Financial Reporting Standard (IFRS), and we have several significant subsidiaries that prepare financial statements in accordance with US GAAP. Thus, we are aware of the current complexities that exist within the two frameworks and support the Board's initiative to address this topic.

US GAAP guidance on classifying instruments with characteristics of equity is located in numerous standards which contain exceptions and inconsistencies. This has led to divergence in practice and therefore we agree that a single comprehensive standard is needed. However, we would like to see more progress on the conceptual framework before the Board reaches a tentative conclusion on the equity/liability project. The Board has not completed sufficient theoretical groundwork for defining equity and liability instruments. Fundamental changes to classification should be considered with a cohesive conceptual framework that defines equity and liabilities.

A single comprehensive standard for classifying instruments with characteristics of equity currently exists in IAS 32, Financial Instruments: Presentation. Although IAS 32 has certain shortfalls, we have found it to be generally workable in practice. We do not believe that IAS 32 is sufficiently broken to require full reconsideration and, therefore, as an alternative approach we suggest that the Board adopt IAS 32 and work towards an improved standard rather than fundamentally rethinking classification of instruments with characteristics of equity.

If the Board proceeds with its project to develop a fundamentally new standard on classification, we do not agree that the basic ownership approach should be adopted. The basic ownership approach appears to achieve the goal of a simple division between equity and liability; however, we don't believe that it will simplify financial reporting overall. The implementation and application issues associated with this approach will add significant complexity to financial reporting, may distort commonly used ratios, and complicate tax reporting. Overall accounting and reporting may be more complex and we are concerned that the typical shareholder will not be able to understand the financial position or performance of an entity.
Under the basic ownership approach many instruments that, in our opinion, represent an ownership interest in an entity will be classified as liabilities. We disagree that an instrument must be the most subordinated residual interest in order to be considered an equity instrument. We believe that an entity can have various levels of ownership and that an instrument that represents an ownership interest, or upon settlement will represent an ownership interest, is equity of the entity. Capital contributed by owners is fundamentally different from a liability of an entity in that it (1) does not establish an obligation to deliver cash or other assets, and (2) it is available to absorb losses of the entity. Such instruments do not meet the current framework definition of a liability, and we do not believe that it is appropriate to classify them as such.

We are troubled by the fact that changes in value of instruments with characteristics of equity will be reflected in profit or loss because such measurements are not indicative of an entity’s operations or financial performance. As such, we believe that the basic ownership approach distorts the financial performance and position of an entity. A consequence of this is that entities will be required to provide detailed explanations of the nature and obligations associated with many items classified as liabilities and users will need to differentiate between gains and losses attributable to an entity’s operations from those attributable to instruments with characteristics of equity. This will only add complexity to the financial statements and hinder their usefulness. Thus, we do not believe the basic ownership approach results in a more faithful presentation of an entity’s financial performance, cash flows or capital structure and therefore urge the Board to adopt an approach that results in classification based on an instrument’s substantive economic characteristics.

For these reasons, and those set out in our responses to the questions raised in the PV document, we strongly urge the FASB to reconsider its support for the basic ownership approach. While simplicity may be an overarching goal of financial standards, we do not believe that this proposal will achieve that goal. We believe that the basic ownership approach is not the appropriate line for distinguishing equity from liabilities and it will introduce user and preparer complexities that outweigh any benefits perceived by this simplicity.

Of the three approaches presented in the PV document, we believe that the ownership-settlement approach most appropriately reflects the economic substance of the instruments within its scope. We acknowledge that this approach results in separation of more instruments into equity and liability components and classification is more complex than the basic ownership approach; however, we believe that this approach is conceptually superior to the basic ownership approach. Under the ownership-settlement approach, instruments that contribute to the available capital of an entity will be classified as equity and the loss absorbing capital of an entity will be appropriately presented. Further, changes in the value of equity linked instruments will not be reflected in the statement of financial performance, which appropriately reflects their economic nature. Our concerns and comments on this approach are further explained in our response to the specific questions raised in the PV document.

Responses to the specific questions raised in the PV document are included in the appendix to this letter. Please contact us at your convenience if you would like to discuss any comments that we have made.

Kind regards

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Appendix

Questions from the Preliminary Views
Financial Instruments with Characteristics of Equity

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?

The basic ownership approach purports to achieve the Board's goal of simplifying the distinction between equity instruments and liability instruments; however, we are concerned that simplicity comes at the expense of faithful presentation. The implementation and application impacts of this approach will be significant and overall will add complexity to financial reporting.

We do not believe that the basic ownership approach results in the most economically faithful presentation of an entity's financial position or performance. Under the basic ownership approach, many instruments that contribute to the loss absorbing capital of an entity will be classified as liabilities and revalued through the income statement. We do not agree with such presentation as it will obscure the true economic position of an entity. Our main concerns with this approach relate to the following:

- Equity instruments must only be the most subordinated residual interest
- Additional complexity to financial reporting
- Classification reassessment required at each reporting date
- Further divergence between accounting treatment and regulatory capital
- Inconsistencies in the proposal could lead to structuring opportunities

**Equity instruments must only be the most subordinated residual interest**
Capital can take various forms and we do not agree that an instrument must be the most subordinated residual interest in order to be considered an equity instrument. We believe that an entity can have various levels of ownership and that an instrument that represents an ownership interest, or upon settlement will represent an ownership interest, is equity of the entity. Capital contributed by owners is fundamentally different from a liability of an entity in that it does not establish an obligation to deliver cash or other assets and is available to absorb losses of the entity. Such instruments do not meet the framework's definition of a liability and we do not believe that it is appropriate to classify them as such.

**Additional complexity to financial reporting**
We are concerned that the simple classification principles of the basic ownership approach come at the price of added measurement and presentation complexity. Aside from other complex valuation issues, the most obvious measurement issue relates to perpetual instruments, where the FASB itself has not yet concluded on the appropriate measurement approach. Further, we are concerned with the proposal to recognize changes in the value of equity-linked instruments in the income statement as these instruments are not related to the entity's financial and operating performance. We do not believe it is appropriate to recognize interest expense for equity settled instruments whose value is based on the net assets of the entity and are concerned that this will distort the true cost of funding a business.

Investors will need to differentiate between gains and losses attributable to an entity's operations from those attributable to instruments with characteristics of equity. Thus, entities will need to provide substantial detailed explanations so that investors can accurately interpret an entity's financial results.
Application of the basic ownership approach may distort commonly used ratios and complicate tax reporting. Overall accounting and reporting will be more complex and we are concerned that the typical shareholder will find it more difficult to understand the financial position or performance of an entity.

Classification reassessment required at each reporting date
The basic ownership approach requires reclassification at each reporting date to ensure that the existing classification is appropriate. Entities that issue multiple equity based instruments could be in a constant state of reclassification as instruments are issued or redeemed. Further, entities whose capital structure becomes more complex over time could see dramatic changes if more subordinated forms of equity are issued. This continuous reclassification process could introduce significant volatility in financial reporting and confuse investors as the capital structure of an entity may be a moving target.

Further divergence between accounting treatment and regulatory capital
The basic ownership approach will lead to further divergence between accounting treatment and regulatory capital treatment. Many instruments classified as liabilities will likely receive capital treatment for regulatory purposes. Any increase in disparity can only lead to confusion and will make it difficult to compare the capital structure of different entities. Further, the classification of an instrument as either debt or equity is relevant for the regulatory capital calculation (credit risk versus investment risk). Today, the calculation follows the accounting classification with limited differences. Any changes would widen the gap between accounting and capital and hence increase complexity rather than reduce it.

Inconsistencies in the proposal could lead to structuring opportunities
Under the basic ownership approach, basic ownership instruments of a subsidiary or consolidated variable interest entity (VIE) would be classified as equity in the consolidated financial statements unless their characteristics change upon consolidation. We believe that this is inconsistent with the underlying principle of the basic ownership approach as at the consolidated level such instruments do not represent the most subordinated residual interest. Further, we believe that this will introduce structuring opportunities as entities could create subsidiaries and VIE's for the sole purpose of creating an equity instrument. For example, a Parent could establish a subsidiary whose only assets are common shares of the Parent. If the subsidiary issues puttable shares as its most residual instrument, equity classification of a derivative on own shares could be achieved at the consolidated level.

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?

UBS does not agree with the FASB's conclusion that perpetual instruments which provide the holder with a share of the net assets of an entity but are not the most subordinated residual interest should be classified as liabilities. Issuance of these instruments increases capital available to the entity. Further, since they do not impose an obligation to deliver cash or other assets we do not believe that they would be appropriately classified as liabilities. Classifying such instruments as liabilities with subsequent measurement through profit and loss distorts the capital structure, reported ratios, financial position, and financial performance of an entity. We have not exhausted all of the potential operational issues, however, in addition to substantial system changes that will be required, we believe that liability accounting will require restructuring of debt covenants and could complicate tax compliance and reporting. This is further evidence of the complexity that will be introduced to financial reporting if the basic ownership approach is adopted. Further, we do not believe that the typical shareholder will understand why something that does not require an entity to incur a cash outflow is recorded as an obligation.
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.

The PV document includes three possible alternatives for measuring perpetual instruments, including:

A. Do not remeasure, but report dividends as an expense either when declared or at regular intervals (if dividends are normally paid each period).
B. Remeasure at fair value with changes reported in income.
C. Determine an expected retirement date and an expected dividend stream and discount using a market-based rate.

As noted above, we do not agree that perpetual instruments should be classified as liabilities. The debate regarding subsequent measurement of perpetual instruments highlights that the basic ownership approach is not as simple as presented in the PV document. While we believe that special treatment will be necessary for perpetual instruments, we are concerned that multiple measurement methods for instruments classified as liabilities under the scope of the guidance suggests that not all liabilities are created equal. This only adds complexity to the understandability of financial statements. One thing not considered in the PV document is recognizing changes in value of perpetual instruments and other instruments with characteristics of equity through other comprehensive income. For the sake of completeness, we believe that the Board should explore this alternative.

Of the three alternatives presented, we believe that Alternative A is the only viable option for measuring perpetual instruments. Although we support this approach, we believe that it undermines the basic ownership approach as it is similar to treating perpetual instruments as mezzanine equity.

Alternative B would require constant remeasurement at fair value. Many of these instruments do not trade in an active and liquid market and therefore valuation models will be necessary on an ongoing basis. Such models will also require entities to make adjustments for the impact of changes in own credit. This will increase costs and complexity and will introduce additional level 3 fair value measurements into financial statement reporting.

Alternative C would be very complex to apply in practice. Such an approach would require entities to determine an expected redemption date, which for some instruments may be ultimate liquidation of the entity. It would also require a hypothetical estimate of dividends which may have little correlation to the ultimate payoff associated with the instrument.

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 of the Preliminary Views operational? For example, can compliance with criterion (a) be determined?

We agree in principle with the proposal to classify basic ownership instruments with redemption requirements as equity if they represent the most subordinated residual instrument. Such instruments participate in earnings of an entity and are available to absorb losses. Thus, their characteristics are more akin to equity instruments than liability instruments. However, unlike perpetual instruments and instruments that are redeemable only on liquidation, instruments that are puttable at the option of the holder create an obligation on the entity which has the ability to impact operations and create liquidity risk. We question why these instruments are afforded equity classification, while perpetual instruments such as preferred stock that have no settlement requirements and do not impact operations or liquidity are classified as liabilities.
With respect to operationality, paragraph 20(a) requires that “the redemption amount is the same as the share of the issuer’s net assets to which the holder would be entitled if it were to liquidate on the classification date.” We are concerned that compliance with this requirement may be operationally difficult and suggest that the Board adopt an approach similar to the IASB, “It entitles the holder to a share of the entity’s net assets in the event of the entity’s liquidation. The entity’s net assets are those assets that remain after deducting all claims on its assets other than basic ownership instruments.”

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 do not believe that it is clear in the PV document that the basic ownership approach requires separation of required dividend payments. We believe that more guidance is needed if such separation is required. A required dividend payment should be separately reported as a liability provided that amount is based on a fixed or declared amount. We agree that this is similar to an interest payment and should be recognized as such. However, we believe that more guidance is necessary on how to apply this requirement to dividends that are required but whose amount vary based on the performance of the entity. The Board should specify how to initially and subsequently recognize the dividend liability.

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. 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 agree that classification should be based on the substance of the contractual arrangement. However, we do not believe that terms outside the contractual agreement (or linked contractual agreements) should be considered when determining classification. Based on our understanding of the proposals, entities would need to consider economic compulsion when determining the substance of an instrument. We believe that the concept of economic compulsion adds complexity to classification decisions. We believe that the Board should exclude economic compulsion from classification decisions.

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 the concept of linking instruments so as to eliminate the opportunity to choose between alternative accounting results by altering the structure of an arrangement. However, we are concerned that application of the linkage criteria could be difficult for large entities with different business lines that transact in a global market. Validation of linkage transactions with the same or related counterparty may not be feasible because of information barriers between departments.
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 agree with the conclusion that derivatives on own equity should be classified as assets or liabilities with changes in fair value reporting in income. Such instruments provide a return that is consistent with an ownership instrument and upon settlement may give the holder an ownership interest. Provided that the issuer has the option to settle by delivering equity instruments, the derivatives do not impose an obligation on the entity to deliver cash or other assets and therefore we do not believe that they should be classified as liabilities. It is our view that all treasury transactions (purchase and sale) should be treated as equity. We do not believe that it is appropriate to recognize profit or loss on transactions that will be settled through issuance or purchase of an entity's own equity.

9. 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?

If the basic ownership approach is adopted, we believe shareholders will not understand the true financial position and performance of an entity. Therefore, significant changes to the financial statement will be needed so that users can get an appropriate understanding of the obligations and liquidity risks of an entity. At a minimum, separate display of liabilities that will be equity-settled as opposed to cash-settled will be necessary so that investors can differentiate liabilities that impact cash flows from those that do not.

As previously noted, we believe that the additional disclosure and communication that will be necessary in order to properly communicate an entity's financial position and performance outweighs any perceived benefits from a simple classification between equity and liability.

10. 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.

If the basic ownership approach is adopted, we believe that fundamental changes to the income statement will be necessary so that investors can evaluate profit or loss due to an entity's operations. Separate classification and distinction between changes in equity-linked instruments and non-equity-linked instruments will be needed. We suggest that the Board consider a presentation that would include all changes in value related to equity-linked instruments in other comprehensive income or on a single line in the income statement.

Under the basic ownership approach, many instruments whose value fluctuates with the underlying net assets of the entity would be classified as liabilities. These instruments do not have an implicit or explicit interest rate and the ultimate return is unknown. UBS does not believe that it is appropriate to recognize interest income/expense on instruments that are entitled to a residual interest and whose value is based on the net assets of the entity. This will distort the true funding cost of the business.
Ownership-Settlement Approach

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.

Of the three approaches presented in the PV document, we believe that the ownership-settlement approach most appropriately reflects the economic substance of the instruments within its scope. We acknowledge that this approach results in separation of more instruments and is therefore more complex to apply than the basic ownership approach; however, we believe that this approach is conceptually superior and overall will result in less complexity and a better understanding of financial statements. This approach is most similar to current guidance, but eliminates inconsistencies and codifies the guidance into a single comprehensive standard. Thus, it would represent an improvement to financial reporting.

We note that the ownership-settlement approach results in similar classification as IAS 32. Although IAS 32 has certain shortfalls, we have found it to be generally workable in practice. We do not believe that IAS 32 is sufficiently broken to require full reconsideration and therefore, as an alternative approach, we suggest that the Board adopt IAS 32 and work with the IASB towards an improved standard rather than fundamentally rethinking classification of instruments with characteristics of equity.

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

Yes, we believe that this approach could be simplified.

Classification
The ownership settlement approach classifies as equity only those instruments whose fair value changes in the same direction as the fair value of a basic ownership instrument. We believe that delivery and receipt contracts should be classified as equity provided they are settled by issuance of shares. We do not believe that directional consistency is necessary for equity classification. However, if the Board proceeds with this approach, it should clarify what is meant by 'same direction'. The guidance in paragraph A8 suggests that the instrument must have exactly the same profile (slope) of the underlying equity instrument.

Further, we disagree with the requirement that indirect ownership instruments that provide for cash settlement at the option of the issuer should be classified as liabilities. Such instruments provide a return that is based on the performance of the entity and do not impose an obligation to deliver cash or other assets. Thus, we believe that they should be classified as equity.

Linkage/Separation
We are concerned that the linkage criteria are overly complex, especially for a large company such as an investment bank, where different divisions of the entity enter transactions with the same or related counterparties. Further, the Board should provide clarification with respect to the interaction of the linkage and separation criteria. Under the proposed approach, instruments that are linked may also need to be separated. The order in which these criteria are applied could change the accounting outcome.

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 agree that classification should be based on the substance of the contractual arrangement. However, we do not believe that terms outside the contractual agreement (or linked contractual agreements) should be considered when determining classification. Based on our understanding of the proposals, entities...
would need to consider economic compulsion when determining the substance of an instrument. We believe that the concept of economic compulsion adds complexity to classification decisions. We believe that the Board should exclude economic compulsion from classification decisions.

4. 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 that liabilities that are to be settled with equity instruments should be reported separately from those required to be settled with cash. This will provide investors with useful information about liquidity, the priority of an entity's claims and its financial position.

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

No. We believe that clarification is needed with respect to the interaction of the linkage and separation criteria. Under the proposed approach, instruments that are linked may also need to be separated. The order in which these criteria are applied could change the accounting outcome.

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

The requirements outlined in the PV document for settlement, conversion, expiration, or modification are complex. We believe that detailed examples would help improve understandability.
REO Approach

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.

We do not support the Reassessed Expected Outcome Approach. We agree with the Board that this approach will be operationally complex and would introduce unnecessary complexity. We do not believe that this approach represents an improvement in financial reporting. Thus, we do not believe that further consideration should be given to this approach.

Other Alternatives

1. Some other approaches the Board has considered but rejected are described in Appendix E of the Preliminary Views. 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?

We are currently reviewing the loss-absorption approach presented by the EFRAG and will provide our views on this approach in our comment letter to the IASB.