

BDO Seidman, LLP Accountants and Consultants

233 North Michigan Avenue Suite 2500 Chicago, Illinois 60601 Telephone: (312) 616-4661 Fax: (312) 856-4014

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Via e-mail: director@fasb.org

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 59

File Reference No. 1550-100—Preliminary Views, Financial Instruments with Characteristics of Equity

Dear Mr. Golden:

BDO Seidman, LLP is pleased to offer comments on the FASB Preliminary Views Document, *Financial Instruments with Characteristics of Equity*. We applaud the Board's efforts to improve the accounting guidance for distinguishing between liabilities and equity, which has long been one of the most complex areas of accounting literature. However, BDO does not support any of the approaches described in the Preliminary Views document. Of the three approaches, we believe that the ownership-settlement approach is the most sound and the best starting point for developing a model.

Our main objection to the approaches included in the Preliminary Views is that they lack strong central principles and definitions. The Preliminary Views document barely mentions FASB Concepts Statement No. 6, *Elements of Financial Statements*, which provides the current definition for liability, or the conceptual framework project that is on the agenda and will amend the definitions for asset and liability. Therefore, it is difficult for us to understand how the approaches described in the Preliminary Views are intended to interact with the current and working definitions for liability and equity.

- Would equity continue to be defined as the residual of assets after subtracting liabilities?
- Would equity be defined on a conceptual basis based on principles developed in this project or the Conceptual Framework project?
- Would equity be strictly defined by listing what types of instruments comprise it, thereby rendering the liability classification the residual?

We are particularly concerned by the implication in paragraph D22 that the conceptual framework project would "address differences" created in this project. This suggests that the Board intends to develop the concepts *after* the equity classification criteria are developed. We believe this is an incongruous approach and one that could result in



additional accounting changes in the future. We prefer an approach that a) defines liability and retains equity as a residual and b) supports those definitions with principles describing the characteristics of liabilities (and assets) and equity.

We also observe the conspicuous absence of any discussion regarding convergence. Considering the overall movement to convergent accounting standards and the publicity regarding the possible acceptance of International Financial Reporting Standards (IFRS) for US companies, we think such a discussion would be particularly relevant in light of the fundamental issues being addressed in the liability and equity project.

Our comments regarding the specific approaches are included below.

Basic Ownership Approach

BDO does not believe the basic ownership approach represents an improvement in financial reporting. We have concerns that the basic ownership approach applies a strict definition to equity that puts great pressure on the definition of a liability to capture all instruments excluded from the equity definition. We believe that pressure will create difficulties in the interpretation and implementation of the guidance.

In addition, we believe that the basic ownership approach will provide inferior information to users. We disagree with the assertion in paragraph 62 that the "basic ownership approach more clearly distinguishes between interests of different stakeholders" because amounts attributable to other stakeholders could be identified clearly in earnings. We note that amounts attributable to different classes of equity holders could also be easily identified if they were clearly labeled on the statements of financial position and stockholders' equity.

We agree with the Board that the basic ownership approach would significantly simplify the classification of instruments within the scope of the Preliminary Views document. However, we don't believe that simplification should be the overriding factor in selecting an approach. Instead, as we have stated on several occasions, we believe that simplification should be one of several factors considered in developing a framework and must be weighed against other considerations, like representational faithfulness and relevance. We also believe a certain degree of complexity is acceptable, even warranted, since many of the financial instruments in the scope of the project are significantly complex. An ideal approach would be one that a) is relatively easy to understand and implement and b) provides meaningful information that is comparable across entities.

In addition, we observe that the basic ownership approach could make accounting for certain instruments significantly more complex, for example, perpetual preferred equity instruments that would be accounted for as liabilities. The degree of the increased complexity will depend upon the Board's decisions regarding subsequent measurement of those instruments.



We have the following specific observations on the basic ownership approach:

- It is illogical to us that redeemable common stock would be equity while perpetual preferred stock would be liability. The former appears to represent a current obligation of the entity but the latter would require payment only upon liquidation of the entity (disregarding dividend requirements). We observe that a feature that allows one class of stakeholder to "cash out" of their position before another class of stakeholder represents a form of priority.
- We are unclear as to how the approach would be applied to an entity with no instruments meeting the equity criteria, which might be the case for many private entities. Would an entity always look to the "most residual claim" and therefore every entity would have equity? For example, in the above example an entity has redeemable common stock (equity) and perpetual preferred stock (liability). If all holders redeem their common stock, leaving only the perpetual preferred shares, does that mean the preferred shares would become equity? We find this result illogical and note that identical instruments could be classified differently by different entities.
- Regarding measurement, we are confused by the use of the term "settlement amounts." Paragraph 35 indicates that instruments with "varying or uncertain settlement amounts, for example options and forward contracts...would be remeasured at fair value" each period, while instruments with "fixed maturity dates and settlement amounts" would not be required to be remeasured at fair value. Physically settled forward contracts typically have fixed maturities and fixed amounts that must be delivered at settlement. Therefore, the first sentence would require remeasurement at fair value because the instrument is a forward contract, but the second sentence would not require measurement at fair value because the maturity date and settlement amounts are fixed. We recommend the Board clarify its intent in this regard.
- We question whether use of the probability weighted settlement date for accretion or amortization represents an improvement to current requirements. We note that such a change would result in additional complexity and in some cases could require a discount (premium) to be accreted (amortized) to a date which could not possibly be a settlement date. We believe a more appropriate approach would be to use the redemption date as the accretion (amortization) period consistent with the guidance provided for redeemable basic ownership instruments in paragraph 32.
- In the paragraphs addressing substance (paragraph 44 and A40), the Board refers to the possibility of a stated term or unstated factor that could affect "the instrument's outcome in more than a minimal way." We believe the Board should define or clarify the meaning of what constitutes "more than a minimal way." Alternatively, the Board could base the threshold on terms that are defined in existing GAAP.

Ownership-Settlement Approach

BDO believes that the ownership-settlement approach as articulated in the Preliminary

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Views is flawed, because it lacks a strong principle or definition for equity and does not address how it will interact with the conceptual definition of liability (or asset) that will be provided in the conceptual framework project. Despite this shortfall, of the three approaches we believe the ownership-settlement approach would provide the most meaningful information to users.

We observe that the ownership-settlement approach is the only approach that distinguishes between instruments that provide a choice of settlement form to the holder and instruments that provide that choice to the issuer. We believe this distinction is appropriate, because control over the settlement of an instrument is a significant factor in determining the ultimate outcome and whether the issuer will be required to transfer assets.

While not as simple as the basic ownership approach, we believe the ownership-settlement approach could simplify the accounting for instruments within the scope of the Preliminary Views by requiring a single model of separation of compound instruments into liability and equity components. This approach also appears to include in equity instruments similar to those that are included in equity under current GAAP, for example, preferred shares and warrants. The accounting would be simplified by having the guidance for all instruments in a single standard, as opposed to the host of accounting pronouncements that currently address what qualifies as equity.

REO Approach

BDO does not support the REO approach and does not believe it would represent an improvement in financial reporting. While the REO approach appears to provide meaningful information about the economic realities of financial instruments in the scope of the Preliminary Views, we agree with the Board that the complexity and costs associate with implementing the approach outweigh the potential benefits.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours, BDO Seidman, LLP