LETTER OF COMMENT NO. 16

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Ms. Suzanne Q. Bielstein
Director – Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: File Reference No. 1550-100 – Preliminary Views, *Financial Instruments with Characteristics of Equity*

Dear Ms. Bielstein:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions.

We appreciate the opportunity to comment on the referenced document.

In summary, we support the Financial Accounting Standards Board's (Board's) effort to develop a comprehensive framework for distinguishing between liabilities and equity instruments. We believe such a properly constructed framework would benefit preparers by reducing some of the needless complexity in accounting that exists today and benefit users of financial statements by developing an understandable, internally consistent approach to the determination of which instruments should be treated as liabilities and which instruments should be treated as equity.

This is not to say we believe there is an easy solution to this issue or only one obvious approach to distinguishing liabilities from equity. Unlike physics, there are no "natural" laws governing accounting. There are legitimate arguments that can be made for and against different approaches to resolving this issue. That being said, we do not support the basic ownership approach described in the Preliminary Views document.

We are particularly troubled that the Board's proposal essentially defines liabilities as a residual. We are concerned that the relevance and reliability of financial reporting will be severely compromised by a model that distinguishes between owners and creditors of a business simply by calling the last group in line owners, and everybody else creditors. While we applaud the Board's efforts to create simple, easily implemented standards, the basic ownership model strikes us as one that ignores the substantive and occasionally complex economic differences between liabilities and equity. A standard that is simple and easy is not necessarily a relevant or representationally faithful one.

In the following sections of this letter, we will explain why we believe the basic ownership approach does not provide decision-useful information and explain why we believe a modified version of the ownership-settlement approach is the best approach to distinguishing between liabilities and equity instruments.

Basic Ownership Approach

Decision useful information

The basic ownership approach classifies perpetual preferred stock and "plain vanilla" warrants on a reporting entity's own common stock as liabilities. We believe those instruments are fundamentally different than instruments we would classify as liabilities because the holders of those instruments have no right to demand, at any time, cash or any other asset from the reporting entity. In particular, we note the Board's view that "a claim does not have to create an obligation to be considered a liability." We cannot reconcile this view to a common sense understanding of liabilities. Further, we see the distinction between the "last residual interest" and the "next to last residual interest" as purely artificial.

In our view, perpetual preferred stock and warrants on an entity's own common stock are equity because they represent an interest in the value of the reporting entity after all claims against assets are paid. We agree with the Board's implicit acknowledgement that perpetual preferred stock and warrants on an entity's own common stock are not obligations of the entity any more than common stock is. But unlike the Board, we believe it is far more useful to treat instruments that are not obligations similarly. Further, we do not believe that an obligation to issue shares of common stock is economically equivalent to an obligation to issue cash. The liquidity crisis in some parts of the financial markets over the last number of months has made it painfully clear that liquidity is an important, distinctive economic attribute. We do not believe an obligation to issue common stock is economically equivalent, from a liquidity perspective, to an obligation to pay cash. FASB Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states:

> Important uses of information about an entity's financial position include helping users to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk. Comparisons among entities and computations of rates of return are enhanced to the extent that significant asset and liability groupings are homogeneous in general characteristics and measurement. [Paragraph 29.]

We do not believe the basic ownership approach accomplishes the goals set forth in the Concept Statement for the uses of information about an entity's financial position.

We believe that classifying warrants to issue common shares and perpetual preferred stock as liabilities significantly reduces comparability in financial reporting. Combining instruments for which the holders have no right to demand cash or any other asset from the reporting entity with instruments that do provide such rights to the holders reduces comparability within a reporting entity as well as comparability among reporting entities. FASB Concept Statement No. 2, *Qualitative Characteristics of Accounting Information*, states:

> Greater comparability of accounting information, which most people agree is a worthwhile aim, *is not to be attained by making unlike things look alike* any more than by making like things look different. [Paragraph 119, emphasis added.]

Another concern with the basic ownership approach is that it classifies prepaid forward contracts to acquire a reporting entity's own equity as an asset. We believe a prepaid forward contract is fundamentally different from other instruments classified as assets. A prepaid forward contract entitles the reporting entity to a fixed number of its own shares at some future date. We have difficulty distinguishing a prepaid forward contract from treasury shares. It appears that only the passage of time distinguishes a prepaid forward contract from treasury shares—a distinction that, in our view, has no substance for purposes of defining an asset. We find the conclusion that a prepaid forward is an asset particularly strange given the fixation in the Preliminary Views document with financial "structuring." It seems to us that a reporting entity would be economically indifferent between purchasing treasury shares and purchasing a prepaid forward contract and yet the basic ownership approach would give entities a much different accounting result for one transaction than the other.

Finally, under the basic ownership approach, most share-based compensation arrangements would be liabilities. While we agree that share-based awards provide compensation to employees and that compensation cost should be recognized by the reporting entity, we do not believe obligations to issue equity are liabilities. The rights of stock option holders, for example, and their claims on the net assets of a reporting entity are no different from the rights and claims of common stockholders.

Underlying logic to the basic ownership approach

We believe that in some respects the basic ownership approach confuses the reporting entity with the common stockholder group. That is, from the perspective of the common stockholder group, all instruments with a priority over common stock have the "feel" of a liability. But the reporting entity itself would not have the same view as its common stockholders. Indeed, companies issue perpetual preferred stock, as opposed to debt, specifically because the perpetual preferred stock does not obligate the company to transfer assets. From the reporting entity's perspective, this is a solid basis on which to distinguish liabilities from assets, even though, to a common stockholder, there is little difference between debt and preferred stock issued by the entity.

We are also concerned with the inability under the basic ownership model to independently define a liability. Although we understand that it is possible to define equity and leave liabilities with a residual definition (that is, if it is not equity, it is a liability), we are troubled by such an approach. In our view, an accounting framework that is unable to independently define a liability is suboptimal. How can we expect users of financial statements to find relevance in a model that cannot define equity other than to say "last one in line" and liabilities as "everyone other than the last one in line"?

Other issues with the basic ownership approach

The basic ownership approach would increase the number of differences between the book and tax bases of liabilities. Entities would need to determine if the book/tax basis differences meet the definition of a temporary difference in FASB Statement No. 109, *Accounting for Income Taxes.* We believe that most, if not all, such book/tax basis differences would meet the definition of a temporary difference and therefore require recognition of deferred taxes. This appears to be an additional complexity to the basic ownership approach.

The basic ownership approach in the Preliminary Views document does not address the classification of noncontrolling interests. Noncontrolling interests could be a residual for a component of a reporting entity but does not appear to be the lowest residual interest for the reporting entity as a whole. Would noncontrolling interests be equity or liabilities under the basic ownership approach?

Conceptual Framework Approach

We believe the Board should develop a standard based on the existing definition of a liability in the conceptual framework. We were disappointed by the seemingly abrupt dismissal of this approach in paragraph D7 of the Preliminary Views document:

> The Board considered new guidance that would be consistent with the current definition of liabilities but quickly rejected that alternative because of some obvious problems. For example, an entity with publicly traded stock could arrange to use its own stock as a currency to pay almost any debt and, thereby, avoid reporting a liability. Also, some entities (especially smaller nonpublic entities) would have no equity under a strict interpretation of the current definition because all of their stock is redeemable upon death or retirement of the holder.

The two examples of "obvious problems" given in paragraph D7 are unpersuasive to us. With respect to the first example, we find this to be a non sequitur as it presupposes the definition of a liability. As stated earlier, we believe there are substantive economic differences between being obligated to pay cash as compared with being obligated to issue shares of common stock. Payment of cash reduces the amount of assets available to both creditors and owners whereas the issuance of common stock affects only owners. Market evidence of the critical and substantive differences between cash and common stock settled obligations includes the following:

- Significant fair value differences exist between share-settled and cash-settled instruments. The spread is even wider when the shares are not publicly traded.

- The inability to settle cash-based obligations can result in bankruptcy; an inability to settle stock options or perpetual preferred stock cannot.

- The number of cash-oriented measures used by investors far exceeds the number of ownership dilution-oriented measures. EBITDA, FFO, "free cash flow" and similar metrics indicate the importance of cash to both creditors and equity holders. But the dilution of ownership interests that results from the share-based payments is of concern only to equity holders.

- We can think of many loan covenants that restrict cash outflows; we cannot think of a single loan covenant that restricts equity dilution.

With respect to the second example, we believe the same practical accommodation made in the basic ownership approach for entities in which all equity interests are redeemable would be appropriate under the conceptual framework approach.

The conceptual framework approach is similar to the ownership-settlement approach, but differs from the ownership-settlement approach in the following respects:

- An issuer's option to net-cash settle a forward or option would not preclude the issuer from classifying the instrument as an equity instrument. If the entity has an economically viable ability to settle in basic ownership interests in all circumstances, the instrument would be an equity instrument. However, if the reporting entity has little or no discretion to avoid the future sacrifice of cash or other assets, the instrument is a liability.

- Instruments for which the reporting entity has an economically viable ability, in all circumstances, to settle by converting into a variable number of basic ownership instruments with a fixed monetary amount would be classified as equity. However, if the reporting entity has little or no discretion to avoid the future sacrifice of cash or other assets, the instrument is a liability.

- Prepaid forward purchase contracts for a fixed number of shares would be classified as a reduction of equity as the entity only has the right to receive its own basic ownership interests.

- Equity is the residual element under conceptual framework approach. Liabilities is the residual element under the ownership-settlement approach.

We recognize that this approach is neither as simple nor as easy as the basic ownership approach. However, we believe that it is not unnecessarily complex and can be made operational without the use of bright lines or artificial constructs. Further, and perhaps most importantly, it results in appropriately distinguishing between those instruments that are obligations with the potential to affect the entity's liquidity and those that are not.

We would be pleased to discuss any of our comments with the Board or its staff at their convenience.

Very truly yours,

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