



KPMG LLP  
757 Third Avenue  
New York, NY 10017

Telephone 212-909-5600  
Fax 212-909-5699  
Internet www.us.kpmg.com

May 30, 2008



LETTER OF COMMENT NO. 33

Technical Director—File Reference 1550-100  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, Connecticut 06856-5116

### **Preliminary Views – Financial Instruments with Characteristics of Equity**

Dear Technical Director:

We appreciate the opportunity to comment on the Board's Preliminary Views on Financial Instruments with Characteristics of Equity ("Preliminary Views"). We support the issuance of guidance in this area as we agree that the accounting for financial instruments that have characteristics of liabilities, equity, or both is inconsistent, subject to structuring to achieve desired accounting results, and difficult to understand and apply. However, for the reasons summarized below, we do not support the Board's preliminary view that the basic ownership approach would represent an improvement in financial reporting. Instead, we would support the continued development by the Board in conjunction with the IASB of a form of the ownership-settlement approach.

As described below, we believe that the basic ownership approach would impair comparability among entities because similar instruments would be classified differently by different entities when one entity issues a more subordinated instrument. The distinction between liabilities and equity should be based on the terms of the instruments themselves rather than in relation to other instruments issued by the entity and the classification of instruments should be the same for all entities. We also believe that the basic ownership approach is inappropriate because it would allow redeemable instruments to be classified as equity in certain situations. Instruments that may be required to be redeemed for cash or other assets generally should not be classified in equity. As a result of these and other fundamental concerns, we believe the Board should not continue further consideration of the basic ownership approach.

We believe that the approach developed by the Boards for distinguishing between financial instruments that have characteristics of liabilities, equity, or both must have a strong foundation in the conceptual framework in order to yield improved financial reporting and move away from



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 2

the complex accounting standards that currently exist in U.S. GAAP for distinguishing between and accounting for instruments with characteristics of liabilities and equity. We believe that conclusions about the purpose of distinguishing between liabilities and equity should drive the development of an appropriate approach.

### **Purpose of Distinguishing Between Liabilities and Equity**

There are various reasons why users of financial statements would deem it important for the financial statements to distinguish liabilities from equity. For example, users of financial statements could view the distinction important due to concerns about:

- Solvency of the entity
- Dilution of the existing owners' interests
- Obligations that may require the use of cash or other assets
- Priority of claims on the entity's assets
- Identification of instruments that result in an ownership relationship
- Identification of residual interests in an entity

Any of these reasons, which could be related to underlying principles, could be used as the basis for distinguishing between liabilities and equity. Although we support further development of an ownership-settlement approach, we believe that a primary weakness of the ownership-settlement approach as presented in the Preliminary Views is that it attempts to address a number of the concerns listed above. The combination of these concerns causes the ownership-settlement approach in the Preliminary Views to be complex, as a single principle cannot be identified and implemented. The Preliminary Views ownership-settlement approach incorporates (1) the nature of the instrument's return (equity instruments result in an ownership relationship) and (2) the settlement requirements or lack thereof (equity instruments do not encompass a future sacrifice of economic benefit through the use of assets or other means) in the classification of the instrument. We believe the lack of a single, clearly defined principle is a main reason that the current accounting for these financial instruments is complex and difficult to apply. We believe that a form of the ownership-settlement approach that is based on a single principle could be developed that would clearly distinguish between liabilities and equity. Such an approach would provide users with a consistent presentation of instruments and would reduce the current complexity in classifying and accounting for instruments that have characteristics of liabilities and equity. Below we provide additional details on potential application of a form of the ownership-settlement approach.

### **Concerns with the Basic Ownership Approach**

We do not believe that the basic ownership approach would represent an improvement in financial reporting for the following reasons:



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 3

- *Approach impairs comparability among entities* – Under the basic ownership approach, the same financial instrument issued by two entities may be classified differently. One entity may classify the financial instrument as equity and the other entity may classify the same financial instrument as a liability if it has also issued a more subordinated instrument. We believe that the distinction between liabilities and equity should be based on the terms and characteristics of the instruments, not their relationship to other instruments issued by the entity. Financial statements will lack comparability if similar financial instruments are not accounted for similarly.
- *Approach would allow certain redeemable instruments to be classified as equity* – We generally believe it is inappropriate for financial instruments that are required to be redeemed for cash or other assets to be classified in equity.
- *Approach does not contain a conceptual basis for equity classification* – We do not believe that there is a conceptual basis for classifying only the most subordinate interest as equity. We believe that the line drawn by the Board in the basic ownership approach is arbitrary and therefore has no conceptual underpinning.
- *Approach contains significant potential application issues* – Although the basic ownership approach may appear to simplify the accounting for complex financial instruments, the application of this approach will likely still have significant application issues. We believe that it may be difficult for certain entities to determine which of their financial instruments is the most subordinate given the complex terms of many instruments; such as when an entity issues financial instruments that provide the holders with different proportions of residual cash flows. In addition, there would be significant application issues in determining the classification of partnership interests, particularly where the amount received by each partner may vary based on when the partner sells its interests (e.g., during the life of the entity or at liquidation of the entity), the nature of the income or costs incurred, whether specified thresholds are met, or other variables.
- *Approach infers that simplicity is the main objective of financial reporting* – We do not believe that ‘simplicity’ should be an objective of financial reporting if the information provided under a simplified approach does not provide the users of financial statements with the information needed to make capital resource allocation decisions. As these types of financial instruments often contain complex terms, we do not necessarily agree that the economics of the transactions would be understood by the users of financial statements under the basic ownership approach. For example, we believe that the separation of a



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 4

convertible debt instrument into its equity and liability components may be integral to understanding the economics of the transaction. Therefore, the basic ownership approach appears to move beyond the elimination of unnecessary complexity in financial reporting and may not allow the presentation of important information for users of financial statements, which could actually reduce transparency of information.

For the reasons described above, we believe that the basic ownership approach is fundamentally flawed and, therefore, the Board should not devote further efforts to that approach.

#### **Concerns with the Reassessed Expected Outcome Approach**

We agree with the Board that the reassessed expected outcome approach would not be an improvement in financial reporting. As we do not agree with the basic ownership approach for the reasons described above and since the REO approach is based on the definition of a basic ownership instrument, we do not believe that the REO approach provides the appropriate information to the users of financial statements. Therefore, we agree with the Board that this approach should not be further deliberated.

#### **Support for a Form of the Ownership-Settlement Approach**

We support the continued development of a form of the ownership-settlement approach; however, we believe that the approach should provide a clearer distinction between liabilities and equity instruments than the ownership-settlement approach presented in the Preliminary Views. We are concerned that the ownership-settlement approach presented in the Preliminary Views does not provide a single, clear principle for distinguishing between liabilities and equity. As previously stated, the ownership-settlement approach presented in the Preliminary Views combines different bases for distinguishing between liabilities and equity and the combination of those bases adds unnecessary complexity to the application of the approach.

We believe that a form of the ownership-settlement approach that is based on one principle for distinguishing between liabilities and equity would simplify the understanding and application of the approach and would result in an improvement to financial reporting. As such, we have identified two additional alternative forms of the ownership-settlement approach, each of which focuses on one principle for distinguishing between liabilities and equity. The alternatives represent the most broad and narrow ends of the spectrum for the definition of an equity instrument within an ownership-settlement model.



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 5

The principle upon which Alternative 1 is based—an equity instrument does not encompass a future sacrifice of economic benefits through the use of assets of the entity—represents a broad definition of equity instruments. The principle upon which Alternative 2 is based—an equity instrument does not encompass a future sacrifice of economic benefit through the use of assets or shares of the entity—represents a narrow definition of equity instruments. Modifications or exceptions to either of these two principles will result in added complexity in distinguishing between and accounting for liability and equity instruments. Current U.S. GAAP, IAS 32, *Financial Instruments: Presentation* (which is a form of the ownership-settlement approach), and the ownership-settlement approach presented in the Preliminary Views all include modifications and exceptions to these two principles. Those modifications and exceptions result in complexity to the application and understandability of the classification of liabilities and equity.

As the alternative approaches are not based on the premise of a basic ownership instrument described in the Preliminary Views, the scope of financial instruments that would need to be evaluated under the alternative approaches is different from the scope of the ownership-settlement approach described in the Preliminary Views. The alternative approaches would determine whether (1) ownership instruments and (2) any other contract that is settled with ownership instruments or whose fair value is determined by prices of ownership instruments issued by business enterprises are classified as liabilities or equity. All instruments or separated components should be capable of being classified as liabilities or equity.

#### Alternative 1

Alternative 1 is based on the principle that an equity instrument does not encompass a future sacrifice of economic benefits through the use of assets of the entity. Thus, this approach would require that an entity classify a financial instrument that will be settled by the use of assets as a liability. If the issuer may settle the instrument by the issuance of its equity shares, the instrument would be classified as equity because it does not require a transfer of assets as the issuer's equity shares are not considered assets to the issuer.

Under this alternative, the primary distinction between liability and equity instruments is whether the financial instrument provides the holder with a call on the issuing enterprise's assets. Therefore, if a financial instrument provides the holder with such a call, that instrument should be accounted for as a liability even if the instrument has other characteristics similar to equity instruments. An issuer would classify as equity a financial instrument that it has the option to settle in cash or by issuing its equity instruments; however, if the form of settlement is at the option of the holder, the issuer would classify the instrument as a liability.



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 6

This approach would require the separation of financial instruments into liability and equity components and the linking of certain instruments which is discussed below.

The principle for classifying financial instruments on which this alternative is based would be reflected in the following definitions of liability and equity financial instruments:

Liability instrument – any financial instrument that by its terms provides the holder thereof with a call, whether conditional or unconditional, on the enterprise's assets.

Equity instrument – any financial instrument that by its terms does not provide the holder thereof with a call on the enterprise's assets; the holder must rely on actions by management or the enterprise's governing board to receive assets of the enterprise or liability instruments issued by the enterprise.

This approach highlights our belief that the ownership-settlement approach, or any other approach for classifying instruments, must include a definition of both equity and liability instruments and that financial instruments should be able to be classified as one or the other under those definitions. In addition, the definitions should be based on the terms of the financial instruments, not their relative standing compared to other financial instruments issued by the entity. The above definition of a liability could be revised to apply more broadly to all instruments and obligations (rather than only financial instruments) by expanding the definition to include obligations of the enterprise to provide services to another entity.

We believe that the principle upon which Alternative 1 is based is the clearest distinction from a conceptual perspective and that entities would easily be able to determine whether a financial instrument met the definition of a liability or equity. Under Alternative 1, the impact of potential dilution among equity owners would be reflected within equity since the instruments giving rise to dilution would be classified as equity. Information about dilution would be presented in the related notes and reflected in earnings per share.

We acknowledge that such an approach would result in a broader view of equity than is used by the Board in recent standards, such as FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. For example, an obligation to issue a variable number of shares of stock that are worth a specified amount at the date of issuance would be considered an equity instrument under this approach as the holder of the financial instrument does not have a call on the enterprise's assets.



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 7

Alternative 2

Alternative 2 is based on the principle that an equity instrument does not encompass a future sacrifice of economic benefit through the use of assets or shares of the entity. Thus, this approach would require that an entity classify a financial instrument that provides for a future settlement by the use of assets or issuance of its equity shares as a liability. Alternative 2 is based on the conclusion that a settlement in assets or shares represents a sacrifice of economic benefits by existing equity owners. Settling an obligation by issuing shares will adversely affect the interests of the existing holders of the issuer's equity shares by diluting their interests in the issuer's assets, similar to how settling on obligation by transferring assets will adversely affect their interests by reducing the issuer's assets. Therefore, only financial instruments that contain no potential future settlements would be classified as equity. Under this approach, settlement in shares, whether gross or net or for a fixed or variable number of shares, is considered to be economically similar to settlement in cash or other assets and would lead to a financial instrument being classified as a liability.

The principle for classifying financial instruments on which this alternative is based would be reflected in the following definitions of liability and equity financial instruments:

Liability instrument – any financial instrument that by its terms provides for a future settlement, whether conditional or unconditional, by delivery or receipt of the issuing enterprise's assets or equity shares.

Equity instrument – any financial instrument that by its terms does not provide for a future settlement by delivery or receipt of the issuing enterprise's assets or equity shares.

We believe that all instruments that do not meet the definition of a liability (or an asset) would be classified as equity. Similar to Alternative 1, the principle upon which Alternative 2 is based is clear and easily understandable. Alternative 2 would result in a narrower view of equity than the ownership-settlement approach presented in the Preliminary Views and Alternative 1. However, the separation and bifurcation criteria (further discussed below) anticipated in the approach, along with the narrower definition of an equity instrument, would likely cause more financial instruments to be accounted for as multiple components, which could cause complexity and increase the number of instruments that will be marked to fair value on an on-going basis.



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 8

*Separation and Linkage under the Alternatives 1 and 2*

Both of the alternative approaches would incorporate criteria to separate a financial instrument into components based on the terms of the instrument and its cash flows and to link certain separately issued financial instruments for classification purposes. The following paragraphs provide an outline of the analysis that would be required under both of the alternative approaches for separation and linkage.

Prior to a determination of classification, the alternative approaches would require entities to analyze the cash flows of the financial instrument to determine if separate cash flows may occur (separation) or if the instrument contains any derivative-like features that require bifurcation (bifurcation). Under these approaches, a financial instrument should first be considered for separation into components. The financial instrument should be separated and accounted for as separate instruments if two or more separate outcomes, which are outside of the control of the issuer, may occur. Separate outcomes are not alternative outcomes and are not dependent upon one another. After an instrument has been analyzed for separation, the instrument or each separated component should next be analyzed for bifurcation.

Implicit or explicit terms that affect some or all of the cash flows or the value of an instrument or a separated component in a manner similar to a derivative instrument should be bifurcated from a financial instrument or separated component and accounted for separately. Bifurcation may result only if the financial instrument or separated component has two or more alternative outcomes; that is, the outcomes are dependent upon one another (if one outcome occurs, the alternative outcome cannot occur). All of the bifurcation guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, would apply to the analysis unless it is modified in conjunction with this project. Once a financial instrument has been separated into its components or has been bifurcated into its features and host, each component, host or feature would then be analyzed under the definitions of a liability and equity instrument to determine classification.

Two or more freestanding financial instruments (not including bifurcated instruments) would be linked—that is, classified and measured as if they were a single instrument if (1) they are part of the same arrangement and (2) reporting the instruments individually would result in different accounting treatment than if the two instruments were accounted for as one instrument under applicable GAAP (including the application of the bifurcation criteria discussed above).

For example, assume that an entity issues preferred stock with a substantive registration rights penalty. Under both alternative approaches, the instrument would be deemed to have separate outcomes (payment of registration rights penalty is not dependent on and does not impact the



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 9

preferred stock) and therefore would be accounted for as separate instruments. Additionally, as the separated components do not include implicit or explicit terms that affect some or all of the cash flows or the value of the instrument in a manner similar to a derivative instrument or are not subject to derivative accounting, the two components (preferred stock and registration rights penalty payment) would be analyzed under the definitions of liability instruments and equity instruments of each approach to determine classification. Under both approaches, the preferred stock meets the definition of equity and the registration rights penalty payment meets the definition of a liability.

In certain circumstances, the alternative approaches would result in different conclusions when applying the bifurcation criteria, due to differences in the definitions of liability and equity instruments. For example, assume that an entity issues preferred stock that is convertible into publicly-traded common stock. Under both alternative approaches, the instrument would be deemed not to have separate outcomes; however, it would be deemed to have alternative outcomes (issuer may be required to settle in common stock or the preferred stock will remain outstanding). The instrument also contains implicit or explicit terms that affect some or all of the cash flows or the value of the instrument in a manner similar to a derivative instrument (the conversion feature). Therefore, the host and bifurcated feature each would be analyzed under the definitions of liability and equity instruments under each approach to determine classification.

Under Alternative 1, the conversion feature would be classified as equity as it does not provide the holder with a call on the enterprise's assets, as the conversion feature will be settled in common shares. Therefore, the conversion feature would meet the conditions in paragraph 11(a) of Statement 133 and would not be bifurcated as a derivative instrument. The convertible preferred stock, inclusive of the conversion feature, would be classified as equity. However, under Alternative 2, the conversion feature would be classified as a liability as it provides for a future settlement by delivery of the issuing enterprise's shares. Therefore, the conversion feature would not meet the conditions in paragraph 11(a) of Statement 133 and would have to be further analyzed as an embedded derivative under paragraph 12 of Statement 133. As the host contract in this example is preferred stock that meets the definition of equity under Alternative 2, the economic characteristics of the conversion option (a liability) are not clearly and closely related to the economic characteristics and risks of the host contract. Therefore, the conversion option would need to be separated from the host contract and accounted for as a derivative pursuant to Statement 133 under Alternative 2.

For convertible debt instruments, both alternative approaches would require that the conversion feature be bifurcated and analyzed separately from the debt. Under Alternative 1, the conversion feature would be classified as equity as it may be settled in common shares. Under Alternative 2, the conversion feature would not be classified as equity as it provides for a future settlement by delivery of the issuing entity's shares. Based on the analysis described above, the conversion



Technical Director  
Financial Accounting Standards Board  
May 30, 2008  
Page 10

feature would be accounted for as a derivative instrument pursuant to Statement 133 under Alternative 2.

We believe that both alternative approaches would be an improvement to financial reporting over current GAAP and the ownership-settlement approach as presented in the Preliminary Views. Both alternatives make a clear, easy to understand distinction between liabilities and equity. We acknowledge that the Board may decide to develop a form of the ownership-settlement approach that moves away from either the broad or narrow end of the spectrum. For example, the Board could decide to exclude share-based-payment awards accounted for under FASB Statement No. 123 (revised 2004), *Share-Based Payment*, from the scope of financial instruments that would need to be evaluated under the alternative approaches. Another exception might exempt from liability classification certain puttable or redeemable ownership interests, such as interests in mutual funds and partnerships that are redeemable at fair value.

We believe that the Board should consider the alternative approaches to the ownership-settlement approach described in the Preliminary Views in further developing a form of the ownership-settlement approach that is based on a consistent principle for distinguishing between liabilities and equity. Due to the significance of liability/equity issues in accounting and the goal of convergence, it would be ideal for the Board and the IASB to work together on this project to develop the same conceptual basis for distinguishing between liability and equity instruments under both U.S. standards and IFRS. However, we acknowledge that the application issues in this area under IAS 32 may be less extensive than under U.S. GAAP; and thus, the Boards may have different priorities.

\*\*\*\*\*

We would be happy to further discuss the specifics of these issues in more detail at the request of the Board or the staff. If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909-5419 or Enrique Tejerina at (212) 909-5530.

Sincerely,

KPMG LLP