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LETTER OF COMMENT NO. 10

Technical Director File Reference No. 1550-100 Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116

## Financial Instruments with Characteristics of Equity

To Whom It May Concern:

This comment letter contains our observations and views on whether the basic ownership approach to distinguishing between liabilities and equities would represent an improvement in financial reporting. We also comment on the ownership-settlement approach. Before commenting on these approaches, however, we should note that consistency of application across different financial instruments is likely more important than the overall approach that is finally chosen. Further, different overall approaches are likely to lead to different pressures on the Board for "carve-outs" – i.e., exceptional treatments of specific instruments and/or instruments used for specific purposes. It would be naïve not to consider this prospect when choosing an initial course. Only by being consistent and resisting attempts at carve-outs can the Board foster - or at a minimum, avoid impeding - beneficial financial structuring to achieve valid economic objectives without introducing incentives for structuring to achieve solely accounting objectives.

As an example, we note that paragraph 28 of the Preliminary Views states in part "...The Board will need to consider at a future date whether or not share-based-payment awards should be in the scope of any standard resulting from this Preliminary Views." We take this as an acknowledgement that pressure is anticipated for share-based-payment awards. However share-based-payment awards are classified, it is most important to classify any instrument used to hedge (or value) them in a manner that is consistent with the classification of the share-based-payment award itself.<sup>1</sup>

We refer the reader to Zion Bancorporation's comment letter on EITF 0705 dated May 5, 2008, in which note is taken of the difficulties of the current inconsistent classification scheme has generated for Zion's efforts to obtain a market-based solution for valuing employee stock options.

Consistency allows assets and liabilities and offsetting hedge positions to be treated in a mirror image fashion without artificially impacting income statements. This, in turn, encourages companies to focus on the economics of hedging and not on the mere accounting impact. In the above example, if employee stock options are not marked to market it makes no sense to mark to market an offsetting hedge position and, conversely, if the options are marked to market then the hedge must be as well. Without such consistent treatment, the pure accounting motivation for establishing or not establishing a hedge may outweigh the economic considerations of doing so.

#### Basic ownership approach

The basic ownership approach would classify a financial instrument as equity only on the basis of (1) its subordinated standing and (2) its carrying a right to a share of net assets after satisfaction of all higher priority claims. Leaving aside for the moment the issue of substance, this approach renders the *classification* of instruments simpler, as it is a "corner solution" of sorts — only the lowest priority claims would be equities. This will not, however, necessarily lead to simpler *accounting*, as it will classify more instruments as liabilities (or assets) and require more fair value calculations.

It is also unclear whether having the classification depend only on the basis of an instrument's subordination will result in more useful information, or even less structuring to achieve accounting, and not economic, goals. One can imagine a set of financial instruments that places its holders in the most subordinated position in differing circumstances. This is one difficulty faced by the current system: debt becomes equity in bankruptcy. While we cannot at this time foresee the circumstances in which structuring a set of such instruments would be advantageous, our point is that despite seeming straightforward, the basic ownership approach may turn out to be anything but..

Given that it would classify the fewest instruments as equity, the basic ownership approach might therefore lead to the most pressure on the Board in the future for carve-outs. For example, any classification scheme that leads to employee stock options being liabilities is bound to attract pushback from many sources. Start-up companies whose financial instruments are illiquid and whose ultimate success is greatly in doubt would have a forceful argument that they are granting employees a contingent equity, and not a debt instrument.

Finally, an attempt to introduce "substance" risks unwinding any potential gain in simplicity that the basic ownership approach might achieve. We note that the example in the Preliminary Views of the option with a \$0.01 exercise price on a \$100 stock suggests at least three issues. The first is where to draw the line in terms of the moneyness of the option — what if the exercise price is \$0.02 or \$0.03? The second is the importance of considering the volatility of the stock. Surely, the numbers in the example were chosen to suggest that no reasonable volatility would result in the option being out-of-the-money, but in practice one would have to assess moneyness in light of volatility. Finally, similar logic suggests the importance of time-to-maturity. An option deep in-the-money with a low volatility and a little time-to-maturity may indeed be equivalent to equity in terms of

economic substance, but once judgments on substance are allowed it will be difficult to confine them to a narrow region, and the seeming simplicity of the basic ownership approach will be lost.

### Ownership-settlement approach

Adding considerations involving settlement makes sense to us for situations involving illiquid securities: having the obligation to deliver one share of stock, for example, would in that situation be different from having the obligation to deliver a fixed dollar amount. But if this is the case, one wonders how deep this argument might run. For the frequently traded and liquid financial instruments of large public corporations, market opportunities to convert one form of value (e.g., a share) into a another (e.g., dollars) renders keying classification on the terms of settlement arbitrary. However, one important lesson of the recent difficulties with auction rate securities is that what is liquid today may be illiquid tomorrow. Therefore, basing the classification of an instrument in part on what is to ultimately be delivered has more logic behind it than may be apparent.

#### Conclusion

Having made these observations on the basic ownership and the ownership-settlement approaches, we should note that we have not argued that the present system of reporting for liabilities and equities is better than either of them. Clearly, there are well-known difficulties and inconsistencies involved in the current system.

As we said in the first paragraph of this comment, consistency in application across financial instruments (and through time) may be a more important determinant of what constitutes a valuable improvement in financial reporting than the basic approach taken initially

Sincerely,

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