

# **Investors Technical Advisory Committee**

401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | Phone: 203 956-5311 Fax: 203 849-9714

Via Email

\* 155 0 - 100 \*

August 1, 2008

LETTER OF COMMENT NO.

Robert H. Herz Chairman Financial Accounting Standards Board 401 Merritt 7 Norwalk, CT 06856-5116

Re: Financial Instruments with Characteristics of Equity

Dear Mr. Chairman:

At the June 10, 2008 public meeting with the Financial Accounting Standards Board ("Board" or "FASB"), the Investors Technical Advisory Committee ("ITAC") expressed support for the basic ownership approach ("Basic Approach") for distinguishing between equity and liabilities or assets as set forth in the FASB's Preliminary Views, Financial Instruments with Characteristics of Equity ("PV"). This letter elaborates on the basis for ITAC's support of the PV and outlines our response to related issues that were raised by members of the Board at ITAC's June meeting.

We applaud the Board's issuance of the PV and wish to thank the Board for its interest in investors' views on this important matter. For decades financial accounting and reporting standard setters have faced particular difficulty in resolving questions about appropriate and useful distinctions among various liability and equity interests. Part of the problem stems from the fact that the nature of claims against the assets of companies has changed over time and, thus, developing clear and complete financial reporting for those claims has presented standard setters with a continuously moving target.

<sup>&</sup>lt;sup>1</sup> FASB Investors Technical Advisory Committee ("ITAC"), Minutes of Meeting ¶ 16 (June 10, 2008), http://www.fasb.org/investors\_technical\_advisory\_committee/itac\_06-08\_Minutes.pdf [Hereinafter *Minutes*]

<sup>&</sup>lt;sup>2</sup> This letter represents the views of ITAC and does not necessarily represent the views of its individual members, the organizations in which they are employed, or the views of the Financial Accounting Standards Board ("FASB" or "Board") or its staff. For more information about ITAC, including a list of the current members and the organizations in which they are employed, see http://www.fasb.org/investors technical advisory committee/.

<sup>&</sup>lt;sup>3</sup> Financial Instruments with Characteristics of Equity, Preliminary Views ("PV") 5-8 (Fin. Accounting Standards Bd. Nov. 2007), <a href="http://www.fasb.org/draft/pv liab">http://www.fasb.org/draft/pv liab</a> and equity.pdf [hereinafter PV].

<sup>&</sup>lt;sup>4</sup> See Minutes, supra note 1, at ¶ 16.

<sup>&</sup>lt;sup>5</sup> See PV, supra note 3, at 1.

<sup>&</sup>lt;sup>6</sup> *Id.* at 1-2.

Financial innovation and the resulting changes in both the form and substance of transactions between capital users and capital suppliers seem destined to continue with ever-increasing complexity. Notwithstanding the constant change and growing complexity of the legal and financing arrangements, ITAC believes that a FASB and International Accounting Standards Board ("IASB") joint project to improve and clarify the distinction between liabilities and equity for financial instruments and other obligations provides the opportunity for a fundamental rethinking of financial reporting for capital, and the potential for vast benefits to investors and other users of financial reports.<sup>7</sup>

As indicated in the PV, the existing 60+ pieces of accounting literature relating to distinguishing between equity and liabilities is "inconsistent, subject to structuring, or difficult to understand and apply." Thus, to fulfill the potential for the project on liabilities and equity the existing literature must be replaced with a clear set of basic principles that will result in a robust and decision-useful reporting framework that can accommodate new innovations. ITAC believes that such a goal is achievable.

### Basis for Support of the Basic Approach

ITAC supports the Basic Approach because we agree with the Board that that approach has the potential to "provide[] more decision-useful information to investors while significantly simplifying accounting requirements for issuers and their auditors." More specifically, we note that the Basic Approach for determining which financial instruments should be classified as equity is generally consistent with what "has been widely viewed as a classical characteristic of equity."

<sup>&</sup>lt;sup>7</sup> See Letter of Comment No. 56 from Ernst & Young to Technical Directors, FASB & International Accounting Standards Board 3 (May 30, 2008), http://www.fasb.org/ocl/1550-100/52133.pdf ("The result of this effort is critical to improving financial reporting and should be expected to stand the test of time.") [hereinafter E&Y]. The Board has indicated that they plan to use the PV "as the basis for a joint project to develop a high-quality common standard." PV, supra note 3, at 1. ITAC supports that plan.

<sup>&</sup>lt;sup>8</sup> PV, supra note 3, at iii; see E&Y, supra note 7, at 6 ("Comprised of standards that were promulgated over a period spanning more than 50 years, the current US GAAP model for liability and equity accounting is almost unworkable.").

<sup>&</sup>lt;sup>9</sup> PV, supra note 3, at iii.

 $<sup>^{10}</sup>$  *Id*. at 5.

<sup>&</sup>lt;sup>11</sup> Letter of Comment No. 57 from Vincenzo LaVia, Chief Financial Officer, World Bank Group, to Technical Director, FASB 1 (May 20, 2008), <a href="http://www.fasb.org/ocl/1550-100/52134.pdf">http://www.fasb.org/ocl/1550-100/52134.pdf</a>; cf. Letter of Comment No. 28 from David A. Lifson, President, The New York State Society of Certified Public Accountants, to Technical Director, FASB 4 (May 30, 2008), <a href="http://www.fasb.org/ocl/1550-100/52105.pdf">http://www.fasb.org/ocl/1550-100/52105.pdf</a> ("The basic ownership approach is consistent with the economic substance of the instrument.").

For example, the CFA Institute includes the following analogous definition of equity in its long-standing proposed business reporting model:

[E]quity is the interest of . . . the last residual claimants, in the net assets (assets minus claims) of the enterprise. Hence, all other interests, including all remaining classes of shareowners whose interests precede and are preferential to those of the residual . . . , should be recognized as senior claims to the . . . equity and accounted for consistently. 12

We agree with the Board that the comparable treatment of senior claims under the Basic Approach better reflects the underlying changes in the economics of the claims of capital providers against the assets of the reporting company and the returns that they can reasonably expect at a given time. We believe that such information is decision-useful to investors and other capital providers as they constantly reassess their investments.

We also believe that the Basic Approach has the potential for providing a much "simpler base" of analysis for users of financial reports. <sup>14</sup> Finally, we agree with other users that the Basic Approach "would make it more difficult to structure transactions to arrive at a specific accounting result." <sup>15</sup>

## Views on Other Related Issues

#### Conceptual Framework Project

The PV explains that (1) the Basic Approach would create inconsistencies with "the definitions of liabilities and equity in Concepts Statement 6;" and (2) the "Board is currently engaged in a joint project with the IASB to reconsider all aspects of the conceptual framework, including the definitions of liabilities and equity . . . ."<sup>16</sup>

<sup>12</sup> CFA Institute, A Comprehensive Business Reporting Model 15-16 (July 2007), http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n6.4818 [hereinafter CFA].

<sup>&</sup>lt;sup>13</sup> See PV, supra note 3, at 18 ("The basic ownership approach increases transparency and comparability in the financial statements."); cf. Letter of Comment No. 47 from Grant Thornton to Technical Director, FASB 4 (May 30, 2008), <a href="http://www.fasb.org/ocl/1550-100/52124.pdf">http://www.fasb.org/ocl/1550-100/52124.pdf</a> ("[W]e believe that consistent measurement of instruments with similar economic payoff is a significant improvement and benefit of the basic ownership approach.") [hereinafter GT].

Letter of Comment No. 4 from Dina M. Maher, Senior Director & Bridget Gandy, Managing Director, Credit Policy, Fitch Ratings, to Technical Director, FASB 3 (Apr. 14, 2008), http://www.fasb.org/ocl/1550-100/51977.pdf [hereafter Fitch]; see also E&Y, supra note 7, at 8 ("In terms of relative simplicity versus complexity, it [the Basic Approach] is certainly a quantum leap from the complexity inherent in the current US GAAP model, and also generally simpler than the current IFRS model . . . . ").

<sup>15</sup> See, e.g., Fitch, supra note 14, at 2.

<sup>&</sup>lt;sup>16</sup> PV, supra note 3, at 57.

ITAC agrees with the Board that the Basic Approach is "consistent with (a subset of) the current definition of equity in . . . Concepts Statement 6 . . . ." and "can stand alone as a reasonable starting point for the definitions of liabilities and equity." Moreover, our view is that the project on liabilities and equity should be explicitly linked to the conceptual framework project so that the definitions developed and further refined in the Basic Approach can be used as a basis for improving the definitions of elements in the conceptual framework. We note that our view is generally consistent with the view of the staff of the United States Securities and Exchange Commission ("SEC") that "the current project on liabilities and equity will address some of the questions about definitions of elements of the financial statements such that work on this project could form much of the basis for needed clarification to the definition of the elements." <sup>18</sup>

## Financial Statement Presentation Project

The PV explains that the FASB and IASB currently are conducting a joint project that addresses the form and content of the basic financial statements. <sup>19</sup> In that project the Boards have tentatively decided that the financial statements should have three sections: the business section, the financing section, and the equity section. <sup>20</sup> The PV notes that most instruments within its scope "likely would be presented within the financing section or equity sections" of the statement of financial position; and most changes arising from the subsequent measurement of those instruments "would be included in the financing section of the income statement." <sup>21</sup>

ITAC supports the Board's tentative approach to presentation of financial instruments within the scope of the PV. We agree that the approach is decision-useful in that it allows investors "to distinguish between changes that are related to financing activities and those that are integral to an entity's business activities."<sup>22</sup>

<sup>&</sup>lt;sup>17</sup> Id. at 58.

<sup>&</sup>lt;sup>18</sup> U.S. Securities and Exchange Commission, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System 37 (June 15, 2005), http://www.sec.gov/news/studies/soxoffbalancerpt.pdf. <sup>19</sup> PV, supra note 3, at 57.

<sup>&</sup>lt;sup>20</sup> *Id.* at 4.

<sup>&</sup>lt;sup>21</sup> *Id*.

<sup>&</sup>lt;sup>22</sup> *Id*.

We also support a separate display within the liabilities section of the statement of financial position and the financing section of the income statement that identifies those items and related income statement components of financial instruments, respectively, that have some of the characteristics of equity but do not meet the Basic Approach definition of equity.<sup>23</sup>

We also support the notion of adding a completely new statement or disclosure that reconciles the beginning and ending balances of the statement of financial position by separately displaying: (1) cash transactions, including current period cash transactions such as interest and dividends paid during the reporting period, and the cash effect of prior period accruals; and (2) non-cash items, including accruals and changes in fair value and estimates.<sup>24</sup> We believe that such a presentation—focusing on disaggregating those income components associated with current cash flows and those that will result in cash flows in other periods—is decision-useful because it more clearly and completely communicates information with better predictive value.<sup>25</sup> Our view again is consistent with that of the SEC staff who has indicated that disaggregating income components "could be useful to users in understanding the results of operations and in evaluating the company's ability to generate cash flows in the future."<sup>26</sup>

Finally, we believe that because of the high level of interdependence of the financial statement presentation project with the projects on liabilities and equity and the conceptual framework—all three projects should be linked.<sup>27</sup>

<sup>23</sup> See Letter of Comment No. 46 from Deloitte & Touche LLP to Ms. Suzanne Bielstein, Director of Major Projects and Technical Activities, FASB 7 (May 30, 2008), <a href="http://www.fasb.org/ocl/1550-100/52123.pdf">http://www.fasb.org/ocl/1550-100/52123.pdf</a> ("We believe the Board should consider separately displaying such instruments in an entity's statement of financial position apart from the entity's other assets or liabilities in recognition of the fact that these instruments have characteristics and risk that are closely linked to the entity's equity.") [hereinafter D&T]; cf. GT, supra note 13, at 4 ("We believe that perpetual instruments should be classified separately from other liabilities.").

<sup>26</sup> United States Securities and Exchange Commission, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers 112 (June 15, 2005), <a href="http://www.sec.gov/news/studies/soxoffbalancerpt.pdf">http://www.sec.gov/news/studies/soxoffbalancerpt.pdf</a> [Hereinafter SEC Report].

<sup>&</sup>lt;sup>24</sup> See CFA, supra note 12, at 29 (Describing the "reconciliation" statement as "essential to our goal of increasing the transparency and understandability of companies' financial reporting and disclosures").

<sup>25</sup> See Letter of Comment No. 64 from Liesel Knorr, President, Accounting Standards Committee of Germany, to Mr. Bob Herz, Chairman of the FASB 13 (May 14, 2008), http://www.fasb.org/ocl/1550-100/52178.pdf ("[A] disaggregation based on income components associated with and not associated with a cash flow should be preferred in providing information with a predictive value.").

<sup>&</sup>lt;sup>27</sup> See D&T, supra note 23, at 1 ("Given the high degree of interdependence between this project and the projects on financial statement presentation and the conceptual framework, we recommend that these projects be closely coordinated."); cf. Fitch, supra note 14, at 4 ("We have a preference for linking the adoption of this standard with the financial statement presentation project.").

### Perpetual Instruments and Measurement

The PV explains that under the Basic Approach "perpetual instruments like some preferred stock, would be classified as assets or liabilities, as appropriate."28 ITAC believes that that classification would clarify the position of such instruments in the claims hierarchy and would eliminate the somewhat artificial distinctions that are currently made between those instruments and other debt instruments with very similar risk and return characteristics.

The Board did not express a view in the PV how perpetual instruments that are classified as liabilities would be subsequently measured.<sup>29</sup> As previously indicated, and consistent with the general view expressed in our May 23, 2008 letter on fair value measurement for financial instruments, 30 we support remeasuring perpetual instruments and all other senior claims against the net assets of an enterprise at their fair value with changes reported in income.31

We believe that fair value remeasurements of financial assets and liabilities improves transparency and investor understanding of the risk profiles of those enterprises that hold or issue such instruments.<sup>32</sup> As one example, information about fair value remeasurements is decision-useful in assisting residual owners in assessing the senior claims on the enterprise's assets.<sup>33</sup> We again agree with the conclusions of the SEC staff that fair value remeasurements for financial instruments "would appear to have benefits in terms of reduced complexity, more understandability, and less motivation to structure transactions to meet accounting goals."34

<sup>30</sup> Letter from Rebecca McEnally, Member, ITAC, to Mr. Robert Herz, Chairman, FASB & Sir David Tweedie, Chairman, International Accounting Standards Board 1-2 (May 23, 2008), http://www.fasb.org/investors technical advisory committee/itac 05-23-08.pdf [hereinafter McEnally].

<sup>&</sup>lt;sup>28</sup> PV, supra note 3, at 5.

<sup>&</sup>lt;sup>29</sup> *Id.* at 22.

<sup>31</sup> See CFA, supra note 12, at 16 ("[C]laims against the net assets that are senior to the residual common shareowners' interest should be reflected at fair value."); Fair Value Measurements, Statement of Fin. Accounting Standards No. 157, ¶C2 (Sept. 2006), http://www.fasb.org/pdf/aop FAS157.pdf ("In many accounting pronouncements, the Board has concluded that fair value information is relevant, and users of financial statements generally have agreed.").

<sup>32</sup> See McEnally, supra, note 30, at 3 ("[A]ll market participants [should] have the information they require to make risk-based financial decisions: clear, complete and up-to-date fair value information."); cf. CFA, supra note 12, at 8 ("Fair value measures reflect the most current and complete estimations of the value of the asset or obligation, including the amounts, timing, and riskiness of the future cash flows attributable to the asset or obligation."); Stephen G. Ryan, Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch 1 (July 2008),

http://www.cii.org/UserFiles/file/resource%20center/correspondence/2008/CII%20Fair%20Value%20Pape r%20(final)%20%20071108.pdf ("The more relevant question is whether fair value accounting provides more useful information to investors than alternative accounting approaches . . . [t]he answer to that question is 'yes.'").

33 See CFA, supra note 12, at 16.

<sup>&</sup>lt;sup>34</sup> SEC Report, supra note 26, at 111.

Finally, we also support requiring specific footnote disclosure of the historical cost or contractual amounts of financial instruments measured at fair value.<sup>35</sup> Such information would be decision-useful, for example, in assessing claims in bankruptcy, long-term forecasting under the assumption of a healthy going concern, or for adjusting for fair value changes in the development of direct method cash flow information (in the absence of direct method cash flow statements, or the reconciling statement or disclosure discussed previously).<sup>36</sup>

# Share-Based Payments

The PV explains that under the Basic Approach an employee stock option would be classified as a liability and subsequently measured at fair value with changes in value reported in income.<sup>37</sup> Consistent with our view on perpetual instruments, we support the Basic Approach to the accounting for employee stock options and would oppose any special exception for those instruments.

Stock-options and other outstanding share-based payments represent a call option or a claim on the net assets of the enterprise in the form of a payment for services rendered. That is, a portion of the assets that would otherwise be available to the residual equity interests has been transferred to the holders. This transfer of interest in the assets is identical in its ultimate economic effect on the residual interest's investment to any other liability, including the enterprise's telephone bill or obligations to the employees' pension trust fund. Thus, it represents a reduction in value of the residual interest and should be recognized as a liability.<sup>38</sup>

Consistent with earlier comments on presentation, we would support an income statement presentation for share-based payments that separately displays the current-period compensation expense from the change in fair value of the share-based payment liability. We believe that such a presentation would provide investors with better decision-useful information about the impact of share-based payments on an enterprise's operating costs and financing costs, respectively.

\* \* \* \*

<sup>&</sup>lt;sup>35</sup> See CFA, supra note 12, at 16 ("We would reiterate that we believe that the historical cost or contractual amounts of such interests should be disclosed in the footnotes to the statements when appropriate.").

<sup>36</sup> See Fitch, supra note 14, at 5 ("[W]e would certainly like to see sufficient required disclosure to enable us to adjust back to the par or settlement values we use in our analysis, as well as disclosure enabling us to

adjust fair value movements out of cash flow."). <sup>37</sup> PV, supra note 3, at 48.

<sup>&</sup>lt;sup>38</sup> See CFA, supra note 12, at 16 ("[I]nstruments, such as stock options, that require the future transfer of a portion of the net assets of current common shareowners to the holders of the instruments must also be classified as claims."); see also Share-Based Payment, Statement of Fin. Accounting Standards No. 123, ¶B43-45 (revised Dec. 2004), http://www.fasb.org/pdf/aop\_FAS123R.pdf (setting forth the arguments for recognizing share-based payments as a liability).

August 1, 2008 Page 8 of 8

We appreciate the opportunity to share with you our current views about the project on liabilities and equity and the related PV. Should you have any questions or would like to further discuss any of our comments in more detail, please contact me at 202.261.7081 or jeff@cii.org.

Sincerely,

Jeff Mahoney Co-Chair

Jeff Malanay

**Investors Technical Advisory Committee** 

cc: Sir David Tweedie, Chairman, International Accounting Standards Board