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Financial Accounting and Reporting Section of the American Accounting Association

Financial Reporting Policy Committee

Response to the IASB's Invitation to Comment on Financial Instruments with Characteristics of Equity¹

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INTRODUCTION

The Financial Reporting Policy Committee (“Committee”) of the Financial Accounting and Reporting Section of the American Accounting Association (“AAA”) is charged with responding to discussion papers and exposure drafts related to financial accounting and reporting issues.² The Committee is pleased to respond to the International Accounting Standards Board’s (“IASB’s”) *Invitation to Comment: Financial Instruments with Characteristics of Equity* (“IC,” IASB 2008). Because the IASB’s IC incorporates, by reference, the entire text of the Financial Accounting Standards Board’s (“FASB’s”) *Preliminary Views on Financial Instruments with the Characteristics of Equity* (“PV,” FASB 2007), this comment letter will contain much of the same discussion included in our PV comment letter filed with the FASB in May 2008.

¹ This comment letter was developed by the members of the Financial Reporting Policy Committee of the Financial Accounting and Reporting Section of the American Accounting Association and does not represent an official position of the American Accounting Association.

² The Committee is independent of the Financial Accounting Standards Committee (FASC) of the American Accounting Association.

According to the IC, the IASB issued the IC for two main reasons: to comply with the mandate included in the February 2006 Memo of Understanding on convergence activities (IC, par. 3-4) and because of existing criticisms of IAS 32 (IC, par. 15-34). The FASB issued the PV in response to an “increase in classification issues” related to liabilities and equity (PV, par. 7). Among the important classification problems described is that “[s]tock issuance is a readily accepted substitute for cash payment because if the markets are deep and liquid the two are interchangeable for many entities.” Because an entity’s own stock is not an asset of the entity, the obligation to deliver common stock is generally interpreted to not satisfy the definition of a liability contained in the FASB’s Statement of Financial Accounting Concepts (SFAC) No. 6: *Elements of Financial Statements* (1985). Further, given the perceived arbitrary nature of the actual physical form of settlement (i.e., assets, like cash vs. an entity’s own stock) and the complexity of the authoritative literature related to liabilities and equity (e.g., the PV refers to over 60 pieces of authoritative literature within its scope), the PV suggests that the existing accounting guidance causes an unacceptable level of nonsubstantive, financial-reporting-outcome-focused transaction structuring.

Although the IC includes the full text of the PV, the IC explicitly states that the IASB has not deliberated any of the conclusions contained in the PV (IC, para. 2). However, given the significant reliance placed by the IC on the PV, many of our comments are directed at the questions, assertions and emphasis included in the FASB’s PV document.

As noted in the IC, the PV describes three possible equity-attribute-based approaches (i.e., basic ownership [“BO”], ownership-settlement, [“OS”], and reassessed expected outcomes, [“REO”]) for distinguishing equity instruments from non-equity instruments (these non-equity instruments are usually liabilities, but sometimes are assets). The PV also clearly conveys the

FASB's preliminary decision that the BO approach is the most appropriate for identifying the financial instruments that should comprise equity. While all three approaches include instruments that satisfy the definition of a "basic ownership instrument," the BO approach limits reported equity to the residual claim embodied in *the* (i.e., one) basic ownership instrument. The OS and REO approaches are not quite as restrictive in their definition of equity; for example, the OS approach includes in equity (1) the basic ownership instrument, (2) other instruments that are ownership interests in legal form, and (3) other contracts settled in basic ownership instruments or whose price is determined by prices of basic ownership interests.

Appendix E of the FASB's PV summarizes the extensive history of the liabilities-and-equity portion of the financial-instruments project. During this time period, the AAA's FASC (1992; 1999; 2001) published three comment letters related to liability-and-equity classification issues, while members of the organizing committee for the 2004 AAA/FASB conference published an award-winning commentary related to accounting for liabilities (Botosan et al. 2005). The conceptual and research-related analyses included in those four published papers are germane to the fundamental issues underlying the distinction between equity and liabilities. Although we refer to these published commentaries in the present letter, the Committee strongly recommends that the IASB and staff refer to FASC (1999), FASC (2001), and Botosan et al. (2005) as input for this IC.

Before addressing any of the method-specific issues in the IC, the Committee wishes to express its concern that the perspective taken in the IC/PV is much more expansive than the usual transaction, event, or instrument-specific accounting matters typically addressed in past standard-setting releases. Instead, the IC proposes (in the questions listed in Appendix B and by reference to the FASB's original PV release) completely new, positively determined, attributes-

based definitions for a heretofore residually defined, primary-financial-statement element (i.e., equity). The Committee believes that the financial statement elements have a position of primacy in our accounting model and only should be redefined as part of a comprehensive reanalysis of the conceptual framework and all of the financial statement elements defined therein.

We are aware that the FASB and IASB have undertaken a joint, comprehensive conceptual framework project; however, we are concerned that the definition of equity is being re-deliberated in an isolated, stop-gap project that (1) is intended to correct specific perceived abuses by reporting entities and (2) appears to be largely independent of the preliminary, theoretical, elements-related work being conducted on the conceptual framework project. In some ways, the IC's apparent *de facto* rejection (mainly via the PV) of the current conceptual framework definition of the liabilities element, along with its primary focus on curtailing transaction structuring, is reminiscent of past concerns expressed about past standard setting bodies (e.g., the Committee on Accounting Policy and the Accounting Principles Board as described in Storey and Storey 1998, 46).

In general, the Committee is not convinced that proposed financial reporting alternatives (and, in this case, a wholesale reclassification of instruments inconsistent with the definition of the elements) should be evaluated primarily on the dimensions of relative simplicity or the ability to curtail transaction structuring. Although we concur that simplicity is desirable, *ceteris paribus*, we view realized levels of transactional or reporting complexity as a financial reporting constraint, not an objective. The Committee also believes that a goal of reducing nonsubstantive, reporting-outcome-focused transaction structuring is likely better addressed by regulators (e.g., the Securities and Exchange Commission), rather than by standard setters.

In addition to the questions posed in the PV by the FASB, Appendix B of the IASB's IC solicits comments on four specific issues (i.e., question B5 is a nonspecific solicitation of general comments). The PV solicits comments on 22 separate issues, 11 of which are related to the basic ownership (BO) approach favored by the Board. The remaining 11 issues relate to the two preliminarily rejected approaches described in the PV (i.e., the OS approach and the REO approach) and other potentially unidentified approaches the Board should consider. Our letter will not individually address many of the detailed, method-specific questions presented in the PV. Instead, our letter much more directly addresses questions B1 and B2 included in Appendix B of the IC.³

Although we address common elements of each of the proposed approaches, we focus much of our commentary on the relatively new, narrow construction of equity operationalized under the BO approach proposed in the FASB's PV. This is because the narrow construction reveals problems inherent in the attributes-based definition of a "basic ownership instrument." Specifically, we address the following questions in the sections that follow:

1. Are the principles underlying the BO approach, and in the restricted definition of BO instruments, clear?
2. Are the principles underlying the BO approach, and in the restricted definition of BO instruments, appropriate?
3. Would the BO approach, and in the restricted definition of BO instruments, significantly simplify the accounting for instruments within the scope of the PV?

³ The remaining two specific questions in Appendix B of the IC (i.e., Questions B3 and B4) solicit comments on jurisdictional and entity-specific concerns about the BO Approach and the other methods described in the FASB's PV. The Committee's evaluation and suggestions are mainly conceptual in nature, so they provide perspectives that are not tailored to specific jurisdictions or entity structures.

Based on our analysis of these questions, the Committee concludes that the principles underlying the BO approach, and in the restricted definition of the BO instrument, are not clearly defined; are not appropriate given the extant Conceptual Frameworks; and will not simplify accounting for instruments that are within the scope of the IC. Specifically, the principles are not clear because the articulated *definition* of priority is based either on subordination or liquidation while the operational criteria appear to be based on dilution-related factors. Further, the principles are not appropriate because they are inconsistent with the extant Conceptual Framework and would significantly increase the heterogeneity of financial instruments reported in liabilities. This increased heterogeneity will also likely lead to reduced decision usefulness of reported liabilities and equity information.

Although a mechanistic approach could simplify the process of balance sheet classification of equity, any simplification gained via a single-instrument equity class is likely quite small in comparison to the significantly increased complexity in the definition, measurement, and interpretation of reported net income and comprehensive income. Finally, the Committee concluded that the suggested identification criteria for a basic ownership interest (i.e., the only financial instrument classified in equity under the BO approach) fails to evaluate important characteristics of ownership interests; thus, the equity-classification simplicity derived from the BO approach is likely illusory. We address each of the forgoing questions in the sections that follow.

**I. ARE THE PRINCIPLES UNDERLYING THE BO APPROACH, AND THE
RESTRICTED DEFINITION OF BO INSTRUMENTS, CLEAR?**

The IC/PV defines a basic ownership instrument as the lowest priority claim; thus, the definition of equity has the apparently desirable attribute that it does not depend on the definition of a liability. However, under the proposed accounting, the definition of equity now depends on the definition of the lowest priority claim, which the Committee concluded is ambiguously specified in the PV. For example, within the FASB's PV, the lowest priority claim is described variously as (a) legally subordinated to other ownership interests (footnote 2), (b) having the lowest priority in liquidation (footnote 10), and (c) effectively subject to dilution of value by other ownership interests (paragraph 68). As the Committee outlines in the following discussion, each of these notions of priority is distinct; however, they are neither equivalent, nor internally consistent. More importantly, the Committee's analysis suggests that the basic-ownership-instrument definition is not operational for even the least-complex instruments.

Priority Based on Legal Subordination: By definition, legal subordination must derive from statutory, contractual, or equitable enforceability. Therefore, legal subordination is state, context, and jurisdiction dependent. For example, an instrument may be legally subordinated only with respect to bankruptcy-contingent distributions or with respect to certain contractually specified decision rights. "Junior," or reduced-voting, common stock is an example of a common form of legal subordination with respect to decision rights in the United States.⁴ Legal subordination of decision rights may be combined with other types of legal subordination or with legal preferences. In Germany, "junior" shares are often called "preference" shares because reduced-voting shares typically have a preference for current dividends. However, neither junior shares nor preference shares typically has legal priority in liquidation. The identification,

⁴ Gompers et al. (2008) estimate that up to 10% of large publicly-traded firms have dual class shares. In many cases the super-voting shares are created to maintain concentrated control and do not trade.

evaluation and weighting of important context-dependent combinations of contractual provisions (e.g., establishing legal subordination and legal priority) is not described in the PV.

Also unclear in the definition of lowest priority is whether subordinated decision rights included in junior shares, *ceteris paribus*, are sufficient to result in equity classification of the junior shares because they meet the definition of *the* basic ownership interest (i.e., resulting in liability classification of the super-voting common shares). Just as the exercise of common stock warrants can dilute the proportionate claims of existing common stockholders, the exercise of decision rights can dilute the proportionate claims of shares with subordinated decision rights. For example, when Proctor & Gamble Co. acquired Wella AG, the subset of shares with subordinated decision rights were offered a 30% lower price than super-voting common despite their *equal claim* to distributions in involuntary liquidation. Scenarios such as these suggest that the financial claims of non-controlling interests may be classified as equity because they can be legally subordinated by the exercise of decision rights held by another class of seemingly equity-like instruments.⁵

The Committee's uncertainty about the effect on classification of subordinated decision rights highlights a fundamental and significant conceptual impediment to consistent application of the BO approach: classifying equity based on the relative contractual or statutory priorities of financial claims effectively divorces the concept of equity from the concept of control. In our analysis, this could potentially result in equity comprised entirely of non-voting (or minimally voting) claims.

Priority Based on Liquidation Standing: A second type of priority described in the PV is priority in liquidation (PV footnote 10. As a practical matter, operational (or experienced)

⁵ Wella's non-voting shareholders challenged the price based on arguments of equity but did not prevail (see Norris [2004]).

priority in liquidation settings often arises from economic compulsion or reputational concerns rather than legal enforceability. Thus, we do not view priority in liquidation as equivalent to legal subordination. However, as a working definition used to ascertain the lowest priority claim, priority in liquidation gives rise to many of the same ambiguities as legal subordination because it is state and context dependent.

Liquidation can encompass two broad types business termination: voluntary and involuntary. Because either type of liquidation event is entirely hypothetical for a going concern, financial statement preparers need to construct a hypothetical scenario. If an instrument has priority only in bankruptcy, can priority of that instrument be extrapolated to solvency, or must insolvency be assumed to prioritize the claims? If insolvency is assumed and the value of a particular claim under an insolvency scenario is always zero, would that instrument's priority in liquidation be considered the lowest? In practice, both voluntary and involuntary liquidations may involve negotiated settlements among the claimants that deviate from pre-negotiation contractual or statutory claims. How should the potential for negotiated settlements be factored into the intended hypothetical liquidation scenario?

Involuntary liquidations may be governed by statute or subject to the discretion of a bankruptcy trustee. Should adjudication be factored into the hypothetical liquidation scenario, taking into account the attributes of particular legal or political jurisdictions? In the absence of applicable contract, statutory, or case law, or outside the scope of contractually specified decision rights, how will subordination or priority in liquidation be determined? The Committee concluded that the concepts of legal subordination and priority in liquidation were not sufficiently described or made operational in the PV.

Priority Based on Dilution: Defining the lowest priority claim as a claim that is subject to dilution of value by other claims is independent of legal subordination and priority in bankruptcy. Common equity may be subject to dilution by many financial instruments that do not have priority in liquidation. Unvested options are one example. Hence, this definition and the ones based on legal subordination and priority in liquidation do not result in consistent classification of instruments.

As an independent construct, dilution of value is inadequate to distinguish liabilities from equity. Paragraph 68 describes a situation where the increase in the value of one claim reduces the value of another claim. Under the BO approach, the transferee class of wealth would be classified as a liability and the transferor class would be classified as equity. We note that all claims are subject to “wealth transfers” among the claimants. If compensatory options expire out of the money, then option holders become the transferors (of the fair value of the goods and services previously provided), and common stock holders become the transferees. Wealth transfers between and among debt holders and equity holders is a fundamental tenet in finance.⁶ Repurchase of one class of common stock will reduce the assets available for distribution to other classes of stock. Because the values of all claims are potentially dilutive or reduce assets available to satisfy the other claims, we do not believe that this attribute alone is sufficient to distinguish debt from equity.

For these reasons, the Committee observed that the underlying principles of the BO approach, and the definition of BO instruments, are unclear. The following exercise illustrates our concerns. Without consulting Table 2 in the PV, we attempt to classify claims related to the following two examples, using only the criteria provided in the BO approach.

⁶ In a well-known example, Merton (1974) included in a model the observation that equity holders can extract wealth from debt holders by voting to pay dividends or engage in risk-increasing projects.

Example 1: Note 16 of Berkshire Hathaway's 2007 annual report states that "[e]ach share of Class B common stock has dividend and distribution rights equal to one-thirtieth (1/30) of such rights of a Class A share," but that "[e]ach share of Class B common stock possesses voting rights equivalent to one-two-hundredth (1/200) of the voting rights of a share of Class A common stock." Berkshire Hathaway's Class A and Class B shares appear to have meaningful differences between them. Is Class B stock the lowest priority claim (i.e., the super-voting Class A stock would be classified as a liability if Class B is considered equity)?

Example 2: Company B has common stock and unvested or out-of-the-money compensatory stock options outstanding. Are the unexercised options the lowest priority claim (i.e., the common shares would be classified as a liability)?

Figure 1 in this letter summarizes our application of the BO approach to these two specific examples. In each case, we arrive at an equity amount that is comprised entirely of non-controlling and/or non-voting claims and the classification as liabilities of controlling common shares. This occurs because the identification of a basic ownership interest under the BO approach necessarily results in classification of all other claims as liabilities.

The instrument in Example 1 is not included in the set of examples included in Table 2 of the PV. The instrument in Example 2 letter is equivalent to item 8 in Table 2 of the PV; however, we obtain a different answer using the BO definitions of lowest priority claim. Specifically, we classify options as equity, rather than liabilities, when using the BO criteria to classify the claims.

Figure 1				
Example Instrument	Legally Subordinated	Subordinated in Liquidation	Subject to wealth transfers or dilution by other claims	Lowest Priority Claim According to Preliminary Views
Example 1: Berkshire-B shares	Yes. Decision rights are subordinated to A shares	Maybe. Class B shareholders may be compromised in a voluntary liquidation or acquisition of the firm.	Yes. Any disproportionate change in value of A shares (e.g. due to clientele effects) changes the proportionate value of B shares. ⁷	Yes. Neither class has contractual priority in liquidation. Each class can dilute the value of the other, but only the B shares have inferior decision rights which could affect value in liquidation.
Example 2: Unvested or out-of-the-money ESOs	Yes. ESO holders have no legal claim on any assets or distributions. Decision rights are also subordinated because shares under option are nonvoting.	Yes. Unvested ESO holders typically have no statutory or contractual priority in involuntary liquidation, but answer may differ for voluntary liquidation (e.g. “golden parachute”).	Yes. The common owners can approve dividends, thereby reducing the value of outstanding options and increasing common claims. A negative asset outcome can render the options worthless.	Yes.

The rationale for the PV’s classification of options is tied to the dilutive effect that options may have on equity. However, as we note above, dilution is a bidirectional concept that can also occur within the set of financial instruments included within liabilities and within equity. Moreover, our classification is more consistent with paragraph 58 of the PV, which states that essential characteristics of non-equity claims include (at least) partial protection from risk by basic ownership instruments and limited sharing of rewards. While the share of rewards (i.e., upside returns) for options is unlimited, options are not protected from risk by basic ownership

⁷ An analysis of price data reveals that between 1996 and 2008, the closing price of Berkshire B deviated from its theoretical value of 1/30 of the A share price by an average of 1.6%. However, the deviation was as large as 15% on some days, and the price deviation increased during periods of price volatility. The B shares were “under priced” approximately 59% of the time and “over priced” 35% of the time.

interests because their value can become zero well before the value of common equity becomes worthless.

II. ARE THE PRINCIPLES UNDERLYING THE BO APPROACH, AND THE RESTRICTED DEFINITION OF BO INSTRUMENTS, APPROPRIATE?

We limit our evaluation of the appropriateness of the principles underlying the BO approach (and in the definition of BO instruments) to an evaluation of two criteria. First, is the proposed approach consistent with the Conceptual Framework? Second, does the proposed approach increase decision-usefulness of the financial statements?

We use these two criteria because we believe that consistency with the Conceptual Framework is the most important attribute of a Financial Accounting Standard. Further, internal consistency of accounting standards with the Conceptual Framework is important to their understandability and effectiveness. Although we recognize that the IASB and FASB have undertaken joint revision of their conceptual frameworks, no binding consensus on modifications has been reached to-date.

The Committee's framework for evaluating the appropriateness of the BO Approach is consistent with Chambers' (1970) observations about the design of complex systems:

“A complex system is a contraption for doing complex things. Commonly, it consists of subsystems, each doing or designed to do its own thing, but each designed to fit into and be part of the complex system. No subsystem in a well-designed system is inconsistent with the whole system... (i) f it were, we would not call such a system well designed, for inconsistencies will require additional subsystems to offset them (p. 82).”

First, we evaluate decision usefulness (instead of complexity) because decision usefulness is a pervasive qualitative characteristic of accounting information and because simple accounting may not adequately address complex transactions. Second, we believe that well-

designed accounting standards are those most responsive to well-specified objectives. Third, we believe that the inconsistencies with the Conceptual Framework's definition of liabilities inherent in each of the approaches described by the PV will ultimately require additional guidance to offset them which will create greater complexity and demand for more guidance.

Is the BO approach consistent with the IASB's and FASB's Conceptual Frameworks?

Currently the conceptual frameworks of the FASB and IASB define liabilities in terms of present obligations to transfer assets or perform services. Equity is unambiguously computed as a residual amount; assets minus liabilities. If, as proposed by the BO approach, equity is defined as the BO instrument, liabilities will become a new *de facto* residual classification category, encompassing all other credits not elsewhere defined as contra-assets. Consistent with this assessment, the proposed definition for liabilities reads:

“A *liability* is a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership interests (PV, paragraph D11).”

Because a liability outcome is inferred from a reduction of assets available for distribution to BO interests (rather than its reduction of assets available for distribution to non-BO interests) an instrument cannot be classified as a liability without first unambiguously identifying the BO instrument. This is a significant departure from both Boards' conceptual frameworks.

Although some would say that the BO approach is more consistent with a proprietary view than current GAAP, we disagree because the BO approach omits from its classification criteria any consideration of current or incipient decision rights. Our position is consistent with

Sprague (1907), who describes the proprietary view as one that recognizes essential differential rights of claimants rather than grouping them as a class:

“Thus the right-hand side of the balance sheet is entirely composed of claims against or rights over the left-hand side. ‘Is it not then true,’ it will be asked, ‘that the right-hand side is entirely composed of liabilities?’ The answer to this is that the rights of others, or the liabilities, differ materially from the rights of the proprietor...(p. 53).”

Although Sprague (1907) mentions differences in profit and loss participation as one attribute that distinguishes liabilities from equity, he describes as most fundamental the differences in decision rights,

“(t)he rights of the proprietor involve dominion over the assets and the power to use them as he pleases even to alienating them, while the creditor cannot interfere with him or them except in extraordinary circumstances (p. 53).”

Without dominion, the simple existence of a residuary interest is clearly inconsistent with the classical notion of proprietary ownership. Proprietary ownership is multi-dimensional and each dimension must be present.

Paton (1962) disparages the proprietary approach based on the observation that aspects of ownership (including control, risk, and outcome-dependent returns) are inseparably diffused across all claims. He notes that all claimants provide capital and assume risk for return, and that holders of all claims have some measure of control or return that varies with the state of the enterprise. His views are frequently labeled the “entity perspective”:

“To sum up, if all existing corporate stocks and bonds were to be arranged in a series according to the degree of risk attached to each...and if control or any other aspect of ownership were followed in making the arrangement, there would be no clear-cut line of cleavage (page 73).”

Our view is that the existing Conceptual Frameworks of the FASB and IASB reflect aspects of both the entity and proprietary theories. Specifically, all claims likely have present or

incipient attributes associated with the notion of ownership. However, some claims also have attributes associated with liabilities, and this classification is useful. If all claims have some attributes in common with ownership, but only some claims have attributes associated with liabilities, then identifying the attributes associated with liabilities and leaving the other class as the residual category is the only way to meaningfully separate the claims into distinct categories.

Two attributes uniquely identified with liabilities are the existence of a present settlement obligation (by the enterprise) and the requirement to settle that obligation by sacrificing assets (of the enterprise). Debt and preferred stock each to varying degrees possess attributes associated with ownership. For example, holders of these instruments may be endowed with current decision rights and incipient control rights, and the values are potentially residuary. However, only debt embodies a current obligation to sacrifice assets that would subject the firm to default; thus, debt claims are classified as liabilities. In our view, the relative sensibility of defining liabilities versus defining equity is a function of users' perceptions of the relative uniqueness of ownership attributes versus liability attributes.

The committee is most concerned that the IC/PV envisages creating a new financial element definition for equity *at the standards level*. In conjunction with the existing definition of liabilities in the Conceptual Frameworks of both Boards, the new definition results in conceptual vacuity. That is, under the PV, equity is any claim that does not meet the conceptual definition of a liability under the FASB's SFAC No. 6 (1985, para. 49) and the IASB's *Framework for Preparation and Presentation of Financial Statements* (the "Framework," 1989, para. 49(c)), except for claims not meeting the definition of liabilities that are classified as liabilities (i.e., according to the PV). Liabilities are items meeting the definition of liabilities (i.e., FASB's SFAC No. 6 (1985), para. 35; or the IASB's Framework (1989), para. 49(b)), as well as other

items not meeting the definition of liabilities that are classified as liabilities (i.e., according to the PV). In the limit (i.e., under the BO approach), liabilities could include items such as common stock, participating preferred stock, and warrants for which there is no present obligation to transfer assets or provide services.

We view the wholesale reclassification to liabilities of claims not meeting the conceptual definition of liabilities as inappropriate and detrimental. Such a reclassification has potential to reduce classification inconsistencies among a narrow set of instruments that are classified as equity under the PV, but would increase inconsistencies between the liability-classified equity-like instruments and the other liabilities that embody a current obligation to transfer assets. As discussed more fully below, we believe that the increased heterogeneity within the liability category would decrease decision-usefulness.

Does the BO approach, and the restricted definition of BO instruments, increase decision-usefulness?

In addition to concerns about the inconsistency of the BO approach with the Boards' Conceptual Frameworks, the Committee also has concerns about the extent to which the BO-instrument focus will serve external users of financial statements. In the PV, the FASB expresses concern over the complexity of the current literature, which presumably affects both preparers and users of financial statements (i.e., > 60 pieces of literature focused on narrow issues and responsive in nature). Such extensive literature will inevitably increase information processing costs of external users. Information complexity can lead to at least two user outcomes – the adoption of simpler strategies for dealing with complexity or the impairment of their understanding (e.g., Payne 1976, Hirst and Hopkins 1998). As an example, Plumlee (2003)

found evidence consistent with both effects in the context of six tax law changes that were part of the Tax Reform Act of 1986. Due to the complexity of these changes, she found that analysts' forecasts of effective tax rates incorporated the effects of the less-complex law changes, but not those that were more complex.

To a certain extent, however, the narrow nature of much of the current liability- and equity-classification literature suggests that many situations are idiosyncratic (i.e., not widespread), thus mitigating potential user problems due directly to the complexity of the current literature. Moreover, the Committee was unable to identify the user group primarily suffering from this complexity (i.e., sophisticated versus unsophisticated). The FASB's SFAC No. 1: *Objectives of Financial Reporting by Business Enterprises* (1978, para. 34) and the IASB's *Framework* (1989, para. 25) both explicitly indicate that financial-statement information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. In addition, the *Framework* explicitly mentions that users should also have a reasonable understanding of accounting. Given the level of understanding assumed for financial statement users, is there evidence that sophisticated users are currently misled by the balance-sheet classification of debt and equity instruments? Will unsophisticated users be able to more clearly understand these instruments under the restricted approaches suggested in the IC/PV?

In addition to concerns over complexity, the FASB also expresses concerns that this literature is (i) inconsistent, (ii) subject to transaction structuring, and (iii) difficult to understand and apply. The primary inconsistency within the current literature is the classification of certain instruments as liabilities when those instruments will be settled by delivery of a firm's equity, which conflicts with the conceptual-framework definition of liabilities (FASB 1985, para. 35).

As noted above, the proposed BO-instrument-focused approaches produce even greater inconsistencies with the conceptual framework.

The concern over financial structuring can be exemplified by the rise in popularity of a type of preferred stock, Trust Preferred Securities (TPS), which were treated as debt for tax purposes (i.e., interest was tax deductible) but that most issuers treated as equity for financial reporting purposes (Frischmann, Kimmel, and Warfield 1999). Users' difficulty in understanding the complexity of accounting for these types of financial instruments is alleged in the PV, with little support provided for that position.

The Committee recommends that the IASB and FASB provide explicit descriptions and predictions of how the classification of liabilities and equity might adversely affect users' decisions before concluding that the current accounting for such instruments creates difficulty for users. An understanding of the potential adverse consequences of current practice is necessary to evaluate whether any proposed change will improve financial reporting.

The FASC (1999) offers two alternative decision criteria the Boards could incorporate into their deliberations of liabilities and equity classification policy – the “insolvency-risk approach” or the “common-equity-valuation approach.” Both of these approaches are rooted in the perspective of external users of financial statements. The insolvency-risk approach adopts the perspective that a firm may only be forced into insolvency by liabilities; other claims that are “nonobligatory” and cannot force insolvency are considered equity. The common-equity-valuation approach presumes that equity holders have all residual claims after non-residual claims of other securities; thus common equity is the only equity. The majority of prior accounting rules align primarily with the insolvency-risk approach, whereas the PV aligns more with the common-equity-valuation approach.

As described by the FASC (1999), the two approaches differ in terms of how they would categorize obligations vs. non-obligations and residual claims vs. non-residual claims. Securities that are clear obligations are considered liabilities under both approaches, and securities that represent the residual claim on assets are equity under both approaches. Securities that reflect either non-residual claims or non-obligations are viewed differently by these two approaches (e.g., preferred stock and minority interest). The FASC (1999) acknowledge that neither approach is inherently preferable to the other, but consistent application of one or the other is a desirable outcome in terms of increasing the decision usefulness of the liability and equity categories in the financial statements. In explicitly favoring the BO approach, the FASB is proposing that the classifications of debt and equity be revised to be mostly consistent with application of the common-equity-valuation approach, restrictively identifying only one owner class holding one type of BO instrument. The question then becomes, how useful is liability classification of all other securities and recognized claims?

A traditional argument in the academic literature is that recognition versus disclosure and balance sheet or income statement classification rules do not matter, as long as relevant information is captured somewhere in the financial statements and related notes (or the public domain). This argument relies on an efficient market to collectively process all relevant information in companies' financial statements. It is very difficult to prove or disprove this notion, because inevitably there are research-design shortcomings that lead to two equivocal interpretations (Barth 2000). However, if one loosens the noose of an idealistic research design, the clear takeaway from most academic research on recognition-versus-disclosure, or differential classification of financial statement information, is that financial-statement presentation makes a

difference to investors and creditors. Thus, evidence from prior studies lends itself to a conclusion that the partition of debt and equity will matter to external users.

Botosan, et al. (2005) provide a nice discussion of prior research on the importance of the distinction between liabilities and equity, and we only touch on parts of their discussion here. The most directly applicable study was performed by Hopkins (1996), who examined the effects of differential classification of mandatorily redeemable preferred stock. Based on psychology research documenting that individuals use categories to organize their knowledge and prior experiences, he conducted an experiment in which buy-side analysts valued a company issuing a hybrid (i.e., part debt, part equity) financial instrument. Hopkins (1996) predicted that analysts would have prior knowledge of a robust empirical regularity for companies that finance with debt versus equity securities; that is, seasoned issuances of equity are generally associated with stock price declines for the issuer, but that debt issuances are generally value neutral. In the experiment, he manipulated whether the hybrid security (i.e., mandatorily redeemable preferred stock, or MRPS) was classified as either a liability or equity. Analysts' stock price judgments were correlated with the location of the MRPS: analysts observing equity classification predicted lower prices than analysts observing liability classification for the identical hybrid instrument. Presentation-based findings similar to those of Hopkins (1996) appear in numerous other studies as well (e.g., Maines and McDaniel 2000, Hopkins, Houston, and Peters 2000, Gramlich, Mayew, and McAnally 2006), suggesting that financial-statement presentation makes a difference in investors' and creditors' judgments and decisions. However, the Committee cautions the Boards to remember that *none* of these studies suggest a normatively correct classification for liabilities or equity.

Other research finds that users do not naively rely on simple liabilities versus equity partitions when examining financial statements. Several studies examine how various financial instruments are correlated with systematic risk or market prices. The most interesting evidence is presented by Cheng, Frischmann, and Warfield (2003) and Linsmeier, Shakespeare, and Sougiannis (2007). They examine various financial instruments and conclude that investors treat securities like preferred stock differently depending on the financial health of the firm. For example, when insolvency-risk is high, investors treat preferred stock as equity, but when it is low, they treat preferred stock as a debt obligation. Again, the Committee suggests caution in interpreting prior research results: these studies *do not* suggest that investors fail to understand complex financial instruments and do not suggest a normatively correct classification scheme.

How the BO approach would change the decision usefulness of financial statements depends on how we view users. If we believe financial statement users heuristically view the liabilities-equity split, then the BO approach would mechanically lead to increased leverage ratios, which could undermine the effectiveness of extant models for liquidity and valuation analysis. However, if we presume that users process information about financial instruments with diligence (similar to Cheng, Frischmann, and Warfield 2003 and Linsmeier, Shakespeare, and Sougiannis 2007), then users may appropriately condition their interpretations based on disclosed instrument terms and not merely their classification as debt or equity. However, either conclusion is difficult to draw based on current research, which operates in an environment where most sophisticated users presume that equity represents a number of residual claims, not just a single basic ownership residual claim. In addition, no study has investigated the effects of the likely increase in cognitive costs that will arise pursuant to a mandated structural shift in the items included in the currently recognized accounting categories.

III. WOULD THE BO APPROACH, AND THE RESTRICTED DEFINITION OF BO INSTRUMENTS, SIGNIFICANTLY SIMPLIFY THE ACCOUNTING FOR INSTRUMENTS WITHIN THE SCOPE OF THE PV?

Simplicity in financial reporting is cited as an overriding consideration for some FASB members in choosing the BO approach (PV, para. 51). The PV describes the BO approach as a relatively straightforward exercise:

“Determining which instruments are equity is most simply described as drawing a line between different types of claims to an entity’s net assets... If all claims to an entity’s assets were listed in order of seniority, a line could be drawn below any item in that list, and all claims below it would be a residual because they are entitled to a share of anything left over after all senior claims are settled. Thus, the search for the appropriate line between equity and other claims is the search for the appropriate level of residual (paragraphs 52 and 53).”

However, the apparent relative simplicity of the BO approach is predicated on at least four underlying assumptions:

1. that subordination to all other claims is the singularly relevant characteristic of ownership,
2. that the most residual financial claim can be determined based on objective criteria or criteria that are less subject to manipulation or subversive interpretation,
3. that comingling different classes of stakeholders within equity is inherently less transparent and less informative than comingling different classes of stakeholders within liabilities, and
4. that income measurement will be less complex under the BO approach than under other approaches considered.

We address each of these points in turn.

1. Subordination is the singularly relevant characteristic of ownership

As discussed in Section I, we believe that exclusive reliance on subordination-related criteria to determine a single class of equity claims can logically result in equity comprised entirely of non-voting claims. The reason for this apparent misclassification is that the BO criteria capture only one relevant attribute of ownership. Focusing on a single attribute would not result in inconsistent classification if all relevant characteristics of ownership were perfectly correlated. However, modern financial markets make possible nearly complete separation of financial risk-bearing, decision rights, rights to current income and other attributes traditionally associated with ownership.

This separation requires an equity definition to either identify a singularly relevant and unique attribute among those attributes associated with ownership, or to specify the conditions under which one or another of multiple relevant attributes should prevail for purposes of classification at any point in time. We do not believe that the suggested attributes of BO securities sufficiently identifies a unique or singularly relevant ownership attribute. Dilution in value by other claims is not a discriminating characteristic because the values of all claims are jointly determined by claim structures and asset outcomes. Further, subordination in liquidation is not a singularly relevant attribute of ownership. Hence, the focus on BO instruments and its contemplated classifications are extremely difficult to describe logically and likely impossible to translate into an understandable concept of ownership.

One seemingly obvious solution is to incorporate “dominion over assets” into the definition of basic ownership equity; however, a workable definition of dominion is elusive. Dominion in this context is arguably related to the concept of control, the operational definition

of which is at the heart of the FASB's consolidations project that began in 1982 and remains unfinished to this day.

We do not intend to endorse either the proprietary perspective or the entity perspective for accounting in this discussion. We believe that the FASB's Conceptual Framework and the IASB's Framework reflect elements of each. We refer to the traditional notion of proprietary ownership only to point out that any classification approach that does not explicitly consider relative decision rights will constitute a significant departure from existing proprietary accounting theory and business law. We refer to the entity perspective because we are sympathetic to Paton's (1962) suggestion that all claims likely reflect *some* attributes of ownership and that these ownership attributes are state and context dependent. Therefore, any attempt to categorize claims based on differential ownership criteria will be difficult.

In contrast to the pure entity perspective, the Committee's view is that a reported grouping of liabilities provides useful information because these claims embody identifiable and relevant attributes not associated with the other class of claims. The least complex way of distinguishing liabilities from equity and the one most consistent with the accepted elements of financial statements is to classify claims based on distinguishing characteristics associated with liabilities.

2. *The most residual financial claim can be determined based on objective criteria or criteria that are less subject to manipulation or subversive interpretation*

The argument that the BO approach is less complex and less subject to transaction-structuring is based on the assumption that financial claims can be ranked unambiguously in order of subordination based on objective criteria and that criteria relevant for classification cannot be manipulated. As discussed more fully in Section I, we believe that the attributes of BO

securities are highly ambiguous. For example, we could not reach unanimous agreement among our Committee members on the appropriate classification of certain instruments using the BO criteria. A major source of ambiguity about priority arises from the state-dependent nature of claims. For example, both the decision rights and the participation in residual value associated with debt depend on the firm's proximity to insolvency. The claims available to option holders depend on whether the options are exercised or exercisable and whether asset values have increased or decreased subsequent to issuance. Contractual priorities may be effective only in some states of the world.

Another source of ambiguity arises from the need to evaluate instruments that provide priority in some states of the world and subordination in other states of the world. Classification is inherently subjective; it is even more-so when hypothetical scenarios must be formulated or when inconsistent priority and subordination clauses must be evaluated to determine a measure of overall priority or subordination. Because the Committee does not believe that financial claims can be objectively or unambiguously ranked in order of subordination, we do not view the BO-attributes-based approach as materially less subjective than other considered approaches. Although we do not address the potential for intentional manipulation as a first-order concern, we suspect that the ingenuity of the capital markets will prevail when ambiguity creates opportunity for profit-making and when such opportunities are not constrained by regulation and enforcement.

3. *Comingling different classes of stakeholders within equity is inherently less transparent and less informative than comingling different classes of stakeholders within liabilities*

The PV asserts that the BO approach allows users to identify claims that would reduce residual basic owners' share of the reporting entity's net assets (PV, para. 59). Although we do

not think that the BO approach will impair users' ability to identify claims that would reduce residual basic owners' claims, we do not think that this ability would necessarily be improved. First, instruments potentially classified as basic ownership interests are already separately captioned within the equity section. Second, the values are jointly determined so that each claim has the potential to reduce the share of net assets available to other claims. The extent to which such potential reductions are recognized is an issue of measurement rather than classification.

The PV also asserts that the BO-based separation more clearly distinguishes the interests of different stakeholders (PV, para. 62). The basis for this assertion is unclear because any decrease of heterogeneity within equity is accompanied by increased heterogeneity within liabilities. We note at least three ways in which the nature of different stakeholder interests will become less clear under the BO-centered approach. First, the increased heterogeneity of items within liabilities is accompanied by a loss of conceptual meaning of the liabilities category. Therefore, without explicit additional disclosure, users will not know which liabilities embody obligations. Second, comingling within liabilities of claims not having settlement obligations reduces the current information content of leverage ratios widely used for assessing solvency. For two otherwise equivalent firms, a given quantity of preferred stock results in the same leverage ratio as the same quantity of straight debt. Third, changes in equity-instrument values do not give rise to comprehensive income in the current accounting model. The BO approach's remeasurement of redeemable basic ownership interests at current redemption values comingles within equity instruments subject to remeasurement with those that are not (PV, para. 32 and 33).

4. *That income measurement will be less complex under the BO approach than under other approaches considered.*

Classification of all other claims as liabilities has potentially far-reaching implications for income recognition that are likely to increase the complexity of income measurement, presentation and disclosure. For example, current accounting standards require recognition of a capital charge on debt capital. Recognition of periodic interest charges on perpetual, contingent claims classified as liabilities under the BO approach will be necessary to maintain internal consistency with this approach. Alternatively, another systematic approach to recognition of financing expense will need to be developed. The PV does not systematically address measurement or income recognition under any of the approaches. Given the current mix of measurement bases, difficulties associated with income measurement should not be ignored in evaluating whether a given approach will improve financial reporting, increase complexity, or reduce opportunities for manipulation.

Conclusion

In summary, the Committee concludes that the principles underlying the BO approach are not clearly defined, are not appropriate given the extant FASB and IASB Conceptual Frameworks, and will not simplify accounting for instruments that are within the scope of the IC and PV. Specifically, the principles are not clear because the stated definition of priority is based either on subordination or liquidation while the operational criteria appear to be based on dilution-related factors. Further, the principles are not appropriate because they are inconsistent with the extant Conceptual Frameworks and would significantly increase the heterogeneity of financial instruments reported in liabilities. This increased heterogeneity will also likely lead to reduced decision usefulness of reported liabilities and equity information. Although such a mechanistic approach could simplify the process of the balance sheet classification of relatively simple financial instruments, any simplification gained via a single-instrument equity class is

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likely quite small in comparison to the significantly increased complexity in the definition, measurement, and interpretation of reported liabilities, leverage-ratio components, net income and comprehensive income. Finally, the Committee concluded that the suggested identification criteria for a basic ownership interest (i.e., the only financial instrument classified in equity under the BO approach) fail to evaluate important characteristics of ownership interests.

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